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IN THE

Supreme Court of the United States

OCTOBER TERM, 1937.

No. 723.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

NATIONAL GROCERY COMPANY,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR RESPONDENT.

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Containing a history of legislation attempting to compel distribution of corporate earnings commencing with the Tariff Act of 1913 and including all subsequent legislation on the same subject, testimony concerning the meaning of the law before the Committee investigating the Department of Internal Revenue in 1925, Statement by Secretary Mellon, statements of members of the Congress during debates in the Congress, and reports of congressional committees; and showing how the law has been changed and developed to the Revenue Act of 1936 which imposed a graduated tax on undistributed earnings of corporations at the suggestion of President Roosevelt 74

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IN THE

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR RESPONDENT.

Opinions Below.

The opinion of the Board of Tax Appeals, together with the dissenting opinion (R. 17-32), is reported in 35 B. T. A. 163. The opinion of the Circuit Court of Appeals for the Third Circuit (R. 172-180) is reported in 92 F. (2d) 931.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on October 21, 1937 (R. 180). The petition for certiorari was filed January 20, 1938, and was granted February 28, 1938. The jurisdiction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

(1) Whether the Circuit Court of Appeals erred in reversing the determination of the Board of Tax Appeals which held that taxpayer was availed of for the purpose of preventing the imposition of the surtax upon its stockholders, the Government having offered no proof on the subject of taxpayer's purpose and taxpayer's officers and two expert witnesses having testified that the corporation was formed prior to the Sixteenth Amendment; was doing a large chain grocery business; had grown from incorporation to a large business on its own profits; that the surplus was not in excess of the needs of the business and that the purpose in retaining earnings was to continue growth and expansion and for proper corporate purposes.

(2) Is Section 104 of the Revenue Act of 1928 unconstitutional (a) as imposing a frightful penalty to accomplish thereby what Congress may not regulate directly, namely to compel private corporations to pay dividends in order to create a basis for taxation; (b) as violating the Fifth Amendment in that it specifies no standards of any kind for the guidance either of the taxpayer or the Commissioner and is arbitrary, oppressive and confiscatory; (c) as violating Article I, Sec. 1, and Article I, Section VIII, par. 18, in that it permits the Commissioner alone to determine by his own standards upon what corporations to assess the penalty; and (d) as being nothing less than a tax on a purpose, hence void.

The Statute and Regulations Involved.

The statute is printed for ready reference under Point I hereof. Earlier sections of the same law, showing its

development, and copies of reports and debates in Congress are set forth in the appendix, *infra*, pp. 77 to 123.

Summary of Argument.

Section 104 of the Revenue Act of 1928 imposes a penalty of fifty per centum of the net income upon corporations formed or availed of for the purpose of preventing the imposition of the surtax on its stockholders and provides that the fact that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

Respondent, before the Board, offered in evidence facts and schedules showing the entire history and development of the business, and its directors testified their policy had always been to conserve all possible resources and grow and expand on earnings; that the purpose of the corporation was to continue growth and expansion; that in the year under review they were negotiating for the purchase of existing chains of stores; their business was not fully developed; that they had need in the business of all the earnings, and, in the year under review, all assets depreciated enormously, far exceeding net income reported.

The Company had over 2,300 employees, whose wages aggregated over $3,000,000; purchases $20,000,000; sales $25,000,000; rents of $1,000,000; surplus of nearly $9,000,000, which had depreciated about 25% in the year.

The Board of Tax Appeals, disregarding the sworn testimony of the directors, found from the book figures alone that the corporation was availed of for the forbidden purpose, holding that it had not overcome the statutory presumption.

The Circuit Court of Appeals held that there was no evidence, substantial or otherwise, to support the findings of the Board.

Before the Circuit Court of Appeals, taxpayer contended and here contends that the object of Section 104 was to prevent the formation of holding companies for the purpose of tax evasion and that said section does not apply to corporations engaged in a *bona fide* mercantile and manufacturing business having needs for large capital which grow and expand on their earnings and intend to continue growth.

Respondent contended below and here contends that as applied to corporations in *bona fide* business, Section 104 is unconstitutional, in that it is a mere penalty whose purpose is to regulate and control dividend policies of private corporations formed under the laws of the States, in order to create income subject to the surtaxes; further, that said section is nothing less than a tax on a purpose, and, as such, is void; moreover, that said section violates the Fifth Amendment in that no standards are set forth for the guidance either of directors or the Commissioner as to the amount of reserves that may be carried for obsolescence, depreciation and other like business requirements. There is nothing to indicate what dividends must be paid to avoid its imposition and it reposes arbitrary power in the Commissioner and is, hence, oppressive and confiscatory.

It is further contended that said statute is void as reposing legislative power in the Commissioner, enabling him to determine, by standards that he alone sets up, upon what corporations the penalty shall be levied.

This is the first case that has come before the courts where an attempt was made to assess this penalty upon a corporation engaged in active business, formed before the

adoption of the Sixteenth Amendment and which was expanded on its own earnings.

It is submitted that no other decision with respect to the facts properly could be made than that made in the Court below, and that the constitutional questions involved are so serious to corporations engaged in *bona fide* business that this Court should examine them and hold the law invalid.

Statement.

History of the Business: Its Origin and Subsequent Course.

(A) Origin of the Business.

Henry Kohl came to this country in 1887 from Germany a penniless immigrant boy and secured employment in a grocery store in Brooklyn. In 1891 having saved $217.00 he bought a grocery store in Jersey City. By 1900 he had purchased two stores. He lived in the back of the store, cooked his own meals and, as he expressed it, lived "like all poor devils do" (R. 63).

By 1906 he had three stores and formed Henry Kohl Company, a New Jersey corporation.

In 1908 that Company, which did business on credit, lost $4,000.00. Kohl realized he could not continue along the usual lines. After long and serious thought he conceived the idea of establishing cash and carry stores of moderate size, cleanly kept, with no deliveries and no telephones, with goods prominently displayed and conveniently disposed for the work of the employees, and opened one store as an experiment under the name National Grocery Company, doing business in an entirely new way (R. 64). After about six months this store commenced to do a great deal

of business. He later opened two additional stores and incorporated the business into National Grocery Company in 1908 (R. 65). In 1911 he merged the National Grocery Company and Henry Kohl Company under the name of the former, and after the merger had 57 stores. He financed his expansion entirely on his profits (R. 65).

(B) Difficulties in Financing Business.

From the opening of the first store Kohl encountered difficulty in financing his business. He commenced practically without capital; he had practically no credit. He attempted, at one time, to raise capital by issuing stock, but his attempt was unsuccessful. He early realized that in his case success could only be attained by leaving in the business all his gains and profits except sufficient for his bare living.

(C) All Expansions Were on Accumulated Earnings.

From 1908 forward the growth of the Company is graphically shown by the continuous balance sheet (Ex. 6, R. 136), the statement of the stores operated, gross sales and net profits (Ex. 7, R. 138), the amount of Kohl's salary, income taxes paid, and net profits (Ex. 4, R. 133). These exhibits show a steady growth year by year. This was due to hard work, capable management, willingness of Kohl to live simply to attain success, and a consistent policy of ploughing the earnings back into the business for continued growth and expansion.

National Grocery Company never sold any stocks or bonds. In the early days Mr. Kohl tried to sell stock or bonds in Wall Street,

> "but I was not welcome there and was unable to raise any money by that kind of financing. As time

went on and by the method of keeping all of my profits in the business, except what were necessary for my bare living expenses, 'I was independent and did not want to sell it' " (stock) (R. 65-66).

Mr. Kohl never put anything into the business by way of securities or contributions to the capital from the time the business was incorporated (R. 83).

This policy and this management have resulted in gross sales increasing from $181,000.00 in 1908 to over $25,000,000.00 for the year under review (R. 138), and the net profits increased from $4,584.39 in 1908 to the peak profit of $786,466.98 for the year under review (per the books) (Ex. 7, R. 138).

The purpose of the management has always been to keep on growing through the opening of additional stores, or through the acquisition of an existing chain of stores (R. 67, 69, 70, 77, 78, 79, 80).

Net earnings, paid for the warehouses, stables, garages, stores and inventory of merchandise (Exs. 16, 17, 18, R. 148-152).

(D) Plans for Continuous Expansion.

Miss Mullins, treasurer of the Company, testified that throughout his business experience Mr. Kohl planned continually to expand. When he had one store he promised her he would one day have ten stores. After he had ten he planned to have one hundred. When he had two hundred stores he planned to have one thousand. When he got up to six or eight hundred stores he planned to have two thousand stores (R. 78).

The bakery and warehouse were erected to take care of between fifteen hundred and two thousand stores (R. 78).

The number of stores expanded from 3 to 815 by the slow steady method of opening stores one after the other.

It would take about $3,500,000 capital to finance 700 additional stores (R. 68, 69).

For several years prior to 1930 Mr. Kohl had been negotiating to acquire one or more existing chains of stores within territory that could be served from the central unit of the Company.

Mr. Field, President of the Commercial Trust Company of New Jersey, and former President of the New Jersey Bankers' Association, testified:

> "A company like the National Grocery Company cannot expand unless it covers the total territory that can be covered by a motor truck from its central unit, and to get the full advantage of a chain store business they must cover that territory" (R. 87).

Mr. Field said:

> "Mr. Kohl has talked to me once or twice about wanting to purchase other chains of stores, if the opportunity offered. On his behalf, I approached one chain of stores two or three times to see if it was in the market for sale so that Mr. Kohl might buy it, but they showed no evidence of wanting to sell. This was several years ago. I do not recall how long ago" (R. 89).

The National Grocery stores in the year under review were located in Staten Island, the Northern part of New Jersey and Rockland County, New York, all on the west side of the Hudson River and all within trucking distance of the central warehouse in Jersey City. Across the river, in New York, Brooklyn, Long Island and Westchester County, all within trucking distance of Jersey City, was a densely populated area in which there were no National Grocery stores. They planned to enter this area (R. 69).

Miss Mullins testified that in 1929 and 1930 Mr. Kohl discussed with her the purchase of another chain of stores, one being located in Paterson, New Jersey. In 1930 there was under contemplation the expansion of the business and the opening of a chain of stores in New York City. Their plan of expansion was to cover the area within trucking radius of the central warehouse. They made numerous surveys with the idea of opening a chain of stores in New York. Miss Mullins said:

> "That has been constantly in the minds of Mr. Kohl and myself for many years. Every time anybody came to New York and saw the business that was there, and we were so close to it, we hoped some day to get that business. Every time our store superintendents or real estate department made investigations we found the rents were prohibitive for our type of business. It is a matter of cost and expense. We have the ability to finance and have maintained our ability to finance expansion as, if and when the time is ripe, either by buying an existing chain or by buying new stores. That has been Mr. Kohl's purpose in keeping the surplus in his business" (R. 80).

In 1929 and 1930 Mr. Bohack of the H. C. Bohack Company in Brooklyn was alive, and offered to sell Mr. Kohl his chain of five or six hundred stores.

Kohl testified:

> "We had made a careful survey of this business to see if it was profitable for us to buy it, but while the negotiations were pending Mr. Bohack became ill and died. These negotiations were resumed as late as 1935. The Bohack Company is a large concern—five or six million dollars (R. 70).

(E) Safety and Expansion of the Business the Dominant Purpose.

When asked why he kept all the earnings in the business instead of drawing them out, Mr. Kohl testified that he needed them in the business; and that he never had any too much money. He told of his need for large surplus for use in obtaining discounts; for purchasing in large quantities; for use in time of war and scarcity of supplies; for expansion of the business; all of which tended toward security and growth of the business. He said that it had been the policy of the business from the beginning to let profits accumulate for the benefit of the business. He said that if he had adopted a different policy in the good years from 1920 to 1930, he did not believe that the business would have survived the depression so well, and he added that he believed that those concerns that did pay out their earnings in the good years have gone (R. 73).

Miss Mullins testified that it had been Mr. Kohl's opinion from the foundation of the business that he would make more money reinvesting his money in grocery stores than in any other type of investment (R. 77).

The continuous balance sheet (R. 136) shows that from the foundation of the business surplus moneys were invested in stocks and bonds. The amount stood at $750.00 from 1908 to 1910. The book value of the stocks in the portfolio in the year under review was $2,676,061.47, bonds $313,391.27, but in the year under review these securities depreciated in value by over $943,517.42 (R. 146).

(F) Extent to Which the Business Had Grown by 1930.

The policy of thrift adopted by the management showed these results by 1930:

The Company operated 815 stores, an increase of 16 over the preceding year (R. 138); it had 2,332 employees, who were paid wages of $3,132,891.99 (Ex. 9, R. 140); its purchases of goods aggregated $19,993,937.83; it paid rents of $929,918.70, and it earned by discounting its bills payable the sum of $493,719.24 (Ex. 10, R. 141).

Mr. Kohl drew in salary that year $2,000.00 per week, or $104,000.00, and the Company paid Federal income taxes of $103,616.60. Mr. Kohl's personal income tax that year was $11,140.84. The Company paid municipal and state taxes of $36,371.87 (Ex. 4, R. 133).

Miss Mullins testified that in the year 1930 there was a general decline in the market value of all assets, "including our inventory of merchandise, our inventory of groceries, and our inventory of securities" (R. 81). The Company's net worth declined in that one year by over $2,000,000.00.

We show under Point IV-B hereof the extent of this depreciation.

POINT I.

The Statute.

Revenue Act of 1928, c. 852, 45 Stat. 791:

> "SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.
>
> "(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, col-

lected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner, and subject to the same provisions of law, including penalties, as that tax.

"(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

"(c) As used in this section the term 'net income' means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23 (p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner."

It will be observed that the provisions of the section apply, (a) where a corporation is formed for the prohibited purpose, or (b) is *availed of* for such purpose.

POINT II.

National Grocery Company was not formed for the forbidden purpose.

The corporation was formed in 1908 to conduct a grocery business (R. 126), when its capital and surplus was $20,943.46 (Ex. 6, R. 136). It has continued in the grocery business ever since (R. 136). When the Sixteenth Amend-

ment was adopted it had 81 stores, and at the end of the year under review it had 815 stores (R. 138). Under such circumstances it must be conceded that the company was not formed for the forbidden purpose and, accordingly, neither the Commissioner, the Board of Tax Appeals, nor the Court below found that the company was formed for the forbidden purpose.

POINT III.

National Grocery Company was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders within the meaning of the Statute.

(A) Imposition of this penal tax is tantamount to a finding that the company was a party to an attempt to cheat and defraud the Government out of surtaxes, or was intentionally used for such purpose.

The presumption which favors the honesty of the taxpayer requires proof on the part of the Government which excludes any reasonable possibility of a proper, lawful purpose, before an intention to cheat or aid in cheating the Government by preventing the imposition of surtaxes upon its shareholders can be claimed.

> "Fraud is not presumed either as a matter of law or fact, unless under circumstances not fairly susceptible of any other interpretation." Justice Story—*Tucker* v. *Moreland,* 10 Pet. 58, 78.
>
> *Harrison* v. *Vose,* 9 How., 372, 378.

The Government is aided in sustaining this burden by subsection B of section 104, which provides that the fact

"that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax." Even proof of such fact does not relieve the Government of its burden of proof to establish the forbidden purpose.

(B) The statutory presumption only aids the Government where the fact is established that the corporation has permitted its gains or profits to accumulate beyond the reasonable needs of the business.

Clearly the burden is upon the Government to establish at the outset by competent evidence that there was an accumulation of gains or profits beyond the reasonable needs of the business.

In the case at bar the evidence which the Commissioner introduced before the Board was as follows:

EXHIBIT 5. An analysis of the surplus of the respondent from 1913 to 1931, inclusive (R. 134), introduced as petitioner's exhibit by consent (R. 56), and also income tax returns of Henry Kohl from 1922 to 1930, and income tax return of National Grocery Company for the year under review (R. 99, Par. 3).

Mr. Smith, counsel for the Commissioner, said on the trial:

> "Our case will be found chiefly in the schedules of the operations of the National Grocery Company during the year in question and previous years. From that we will ask the Board to make its deductions" (R. 48, l. 40).
>
> "The law presumes, in the absence of evidence to the contrary, that the business transactions of every man are done in good faith and for an honest purpose; and anyone who alleges that such acts are done in bad faith, or for a dishonest and fraudulent

purpose takes upon himself the business of showing the same."

Jones vs. *Simpson*, 116 U. S., 609;
U. S. Industrial Alcohol Co. vs. *Distillers Company of America*, 89 N. J. Eq., 177.

"Fraud is not presumed either as a matter of law or fact, unless under circumstances not fairly susceptible of any other interpretation."

Tucker vs. *Moreland*, 10 Pet., 78.

There was no proof whatever offered by the Commissioner that the gains or profits of the respondent were accumulated beyond the reasonable needs of its business as those needs were before the Board of Directors in their management and guidance of such business. Not a witness testified that the surplus was beyond such needs.

The greatest length the Government goes in its brief before the Court is to contend that from the mere fact that the taxpayer's books show it had a large surplus, part of which was invested in a diversified list of securities, and that in the year under review the principal stockholder borrowed on notes from the corporation $140,000, and in earlier years had borrowed $470,000 additional, an inference may be drawn that the surplus was so large as to be beyond the reasonable needs of the business. We contend no such inference may be drawn.

(C) Establishment of the fact that gains or profits are beyond the reasonable needs of the business is only prima facie evidence of the purpose.

Not until the Commissioner has proved by competent evidence that gains or profits have been allowed to accu-

mulate beyond the reasonable needs of the business does the presumption arise of the existence of the prohibited purpose.

This is clear from a reading of the rather remarkable 104(b) section. Though the Government produce evidence that the accumulation was beyond the reasonable needs of the business, the sole result would be no more than to compel the taxpayer to disclose the facts which motivated its conduct.

Assuming, but not admitting, that there existed sufficient evidence on petitioner's case to disclose the facts, let us examine the proofs to discover such facts—

(D) Respondent's proofs of its actual purposes in retaining earnings.

Respondent in disclosing the facts called as witnesses Henry Kohl, its president, Miss Anna L. Mullins who had been associated with Mr. Kohl in business for thirty years and who was treasurer of the company, Mr. William J. Field, president of the Commercial Trust Company of New Jersey, in which respondent did most of its banking business, and Mr. Frank C. Ferguson, president of the Hudson County National Bank and Chairman of the Port of New York Authority.

From their sworn testimony we find that respondent, ever since the opening of its first store, has pursued one course of conduct, to wit, that of plowing back its earnings into the business with the view of growth, financially and in numbers of stores; that this course of conduct never changed; that the purpose, or object in view, was constant; that such purpose extended prior to 1930 and throughout 1930.

Mr. Kohl:

"I kept all the earnings in the business because I needed them in the business—always needed them in the business. I never had any too much money in my business. That was my judgment. • • • Even with all the capital that the company had we had to borrow money from the banks occasionally as it was needed. We needed it to buy butter and eggs and put them in storage, and to buy merchandise when it was the right time to buy. Frequently you need more money than you have got. It takes all of the money we have got to swing that" (R. 72).

"It has been the habit with us to keep in the business every possible dollar, and let that accumulate for the benefit of the business. I think it is good business judgment and I guess everybody else does. The bankers tell you that. If we had adopted a different policy and in the good years from 1920 to 1930 had drawn out of the business a large part of our profits, I do not think we would have been able to withstand the effect of this depression the way we have. I think those concerns who did do that have gone" (R. 73).

Miss Mullins:

"It is my opinion, as Treasurer of the Company, that in the year 1930 the surplus was not in excess of the reasonable needs of the business, and is not today, although conditions are different. In order to finance the purchase of $20,000,000 worth of merchandise and pay a million dollars in rents per annum, the Company required its surplus, in my opinion. There were times even at that when we were short of cash, and had to borrow temporarily from the banks in order to pay for incoming merchandise" (R. 79).

Mr. Field:

> "The accumulation of these earnings in the past years has enabled the National Grocery Company to buy advantageously and always to have a proper working capital, although in several years leading up to 1930 they found it necessary to borrow money in addition to the money that was available. Their accumulation of the surplus, invested in securities, enabled them to show a proper credit statement and hence their ability to borrow whenever they wanted, at low rates of interest" (R. 88).

He also said:

> "I don't think it was in excess of reasonable requirements and reasonable safety of the business" (R. 86).

Mr. Ferguson:

> "In my opinion for the year ending January 31, 1931, the surplus of the corporation was not in excess of the reasonable needs of the business. In my opinion it was good sound business practice for the company in that year not to declare any dividends, because in view of the times it was important to conserve all cash resources" (R. 93).

(E) The purpose of the Company in investing surplus funds in securities.

The purpose of the management in putting surplus cash in a miscellaneous list of securities was:

Kohl:

> "To invest that money so that when we would need it we would have it. All corporations do that more or less. * * * We wanted to use it all the

time. It was invested because we wanted to have the cash on hand. And those were the days there was very little investment. We had to have the money ready. What will you do with it if you don't invest it? * * * It was part of our business. We carried that money, of course, principally to have the money on hand and get something for it. At the banks you would only get 2 per cent at that time. Of course, you don't get anything now. So we bought some stocks and bonds which we could turn over. You know, you can turn that stuff over in the morning, in a couple of hours, and you have your money if you want it" (R. 75, 76).

"In the early years when we went to the banks to borrow money I had plenty of difficulty in getting credit. I found from actual experience that having those securities in the statement of the National Grocery Company enabled the Company to get credit at low rates where we had been unable to do that in the earlier years" (R. 76).

The Solicitor General in his brief (p. 3) concedes that for a long time respondent had invested its cash in securities with the thought in mind of realizing cash therefrom with the purpose of expanding its grocery stores at any time desired.

(F) Flat denial of the prohibited purpose.

Moreover, respondent affirmatively proved that National Grocery Company was not availed of to avoid taxes. Mr. Kohl testified:

"I did not refrain from paying dividends in the National Grocery Company in 1930 in order to avoid the payment of any government taxes. I have never done that" (R. 75).

(G) All taxes could have been avoided lawfully, had tax avoidance been in the minds of the management.

If there had been any intention on the part of the management of this business to avoid taxes, all it had to do was to dump on the market some of its bank stocks and sell them for what they would bring. Thus a deductible loss under the Revenue Act could have been established sufficient to wipe out all the net profits reported. By that method the Company would have saved income taxes of $103,616.60 which the Company paid, as well as avoided all questions under Section 104.

All of the above mentioned testimony of the officers, who were in charge of the management of this business, was wholly disregarded by the majority members of the Board of Tax Appeals. The opinion of the majority did not even mention the testimony as to purpose given by Mr. Kohl and Miss Mullins. Their opinion had nothing to support it but the statutory presumption and, as we shall show below, that passed out of the case when the taxpayer offered its proofs.

Moreover, the proofs of the taxpayer were in entire harmony with the exhibits which showed what assets and liabilities the business had, its growth and development, and its size.

Every bit of growth, every expansion the business had made from its humble origin had been made on accumulated earnings. The Company had never been financed or expanded through borrowed money. It never borrowed money except on short term borrowings. The Company never sold any stock or bonds to the public. All the expansions of the business had been made out of earnings (R. 77).

(H) In view of the foregoing the presumption is out of the case.

The Commissioner did not call a single witness to dispute or deny any of the above testimony.

In *United Business Corporation* v. *Commissioner, supra,* Judge Hand said:

> "A statute which stands on the footing of the participants' state of mind may need the support of presumption, indeed be practically unenforceable without it, but the test remains the state of mind itself, and the presumption does no more than make the taxpayer show his hand. *Pariso* v. *Towse,* 45 Fed. (2d) 962; *Alpine Forwarding Co.* v. *Pennsylvania Railroad Co.,* 60 Fed. (2d) 734."

In the recent case of *New York Life Insurance Co.* v. *Gamer,* 82 Sup. Ct. Rep. Adv. Opinions 480, 483 (decided February 14, 1938), Mr. Justice Butler said:

> "* * * presumption is not evidence and ceases upon the introduction of substantial proof to the contrary. Thayer, Preliminary Treatise on Evidence, p. 346; Mobile, J. & K. C. R. Co. *v.* Turnipseed, 219 U. S. 35, 43; Western & A. R. Co. *v.* Henderson, 279 U. S. 639, 642, 644; Heiner *v.* Donnan, 285 U. S. 312, 329; Atlantic Coast Line R. Co. *v.* Ford, 287 U. S. 502, 506; Del Vecchio *v.* Bowers, 296 U. S. 280, 286; Nichols *v.* New York L. Ins. Co., 88 Mont. 132, 139. * * *
>
> "* * * presumption is not evidence and may not be given weight as evidence. Despiau *v.* United States Casualty Co. (C. C. A. 1st), 89 F. (2d) 43, 44; Jefferson Standard L. Ins. Co. *v.* Clemmer (C. C. A. 4th) 79 F. (2d) 724, 730, 103 A. L. R. 171; Travelers Ins. Co. *v.* Wilkes (C. C. A. 5th) 76 F. (2d) 701, 705; Fidelity & C. Co. *v.* Driver (C. C. A. 5th) 79 F. (2d)

713, 714; Frankel *v.* New York L. Ins. Co. (C. C. A. 10th) 51 F. (2d) 933, 935; Ocean Acci. & G. Corp. *v.* Schachner (C. C. A. 7th) 70 F. (2d) 28, 31. But see: New York L. Ins. Co. *v.* Ross (C. C. A. 6th) 30 F. (2d) 80; Tschudi *v.* Metropolitan L. Ins. Co. (C. C. A. 8th) 72 F. (2d) 306, 308, 310; Nichols *v.* New York L. Ins. Co., 88 Mont. 132."

Del Vechio v. *Bowers,* 296 U. S. 280, 286;
Metropolitan Life Ins. Co. v. *Armstrong,* 85 F. (2d) 187, 195.

(I) Fallacy of argument for the Commissioner.

The Solicitor General contends in his brief that respondent's accumulations were not needed to acquire new stores, were not needed in the business, and were not needed because of the depreciation in the value of securities or inventory.

No witness testified to any of these contentions. They are nothing but contentions.

When the Solicitor General argues that the Circuit Court of Appeals overlooked or disregarded an array of facts and circumstances which, "together with proper inferences to be drawn therefrom, not only discount the testimony it relied upon, but amply justify the findings of the Board," he asks the Court in effect to displace evidence with conjecture, surmise and inference.

We submit that the inferences which can properly be drawn from an examination of the balance sheet are very limited. The balance sheets on their face show the relation between capital and surplus, assets and liabilities. One cannnot infer from looking at a statement showing the number of stores in operation year by year anything about the location of such stores. One cannot tell from

looking at the statements in evidence whether the management was planning to expand the business in Brooklyn, the Borough of Manhattan, or the Bronx or Westchester County.

The *factum probandum* in this case is purpose of the management. That cannot be inferred from a mere examination of books. That can only come from the minds of the directors and officers. When directors testify that their purpose is one thing and their actions show their purpose is something different, they may be disbelieved. Here, however, the course of the conduct of this business from its origin shows that the motivating purpose throughout has been growth and expansion on earnings. The management under oath revealed their purposes for the future, their plans and the reason for them.

The Solicitor General argues that because the Company could have paid dividends and did not, therefore its purpose was to evade the surtaxes. Not so!

The fact that the Company had on deposit in bank $1,400,000.00 at the end of the year does show an *ability* to pay a dividend. It does not, however, prove that the reason a dividend was not paid was for a fraudulent purpose. The attitude of the Government is that if the Company could pay a dividend and did not, *ipso facto* the forbidden purpose was proved. The statute does not say so.

This argument would not only cast the burden of proof on the taxpayer, (which the Board of Tax Appeals did (R. 22, 23)), but also it would make it liable for the penalty.

The purpose to evade surtaxes must be shown by clear and convincing proof to have been the *sole* aim and object of the directors before this highly penal tax can be assessed.

The exercise of directors' discretion turns on business

expediency and not on strict necessity or rules of law—not on the whims or predilections of the Commissioner.*

Obviously no two situations are alike and the views of business men must be as different as the men themselves. Some are bold and venturesome. Others are conservative and cautious. Some look to the future. Others only to the immediate. Until our form of government changes to strip from business men the right and discretion to manage the affairs of corporations with what is commonly called "horse sense", neither the courts nor government officials will have the right or power to displace the exercise of directors' discretion, though they have been guided by their personal views of expediency.

If, therefore, the act of directors in retaining earnings and withholding dividends is consistent with their view of business expediency, if a purpose or aim foreign to the accomplishment of the business objects of the corporation is not clearly and convincingly shown to have shaped their acts, the Commissioner must be held to be without power to set aside their acts and impose the penalty tax of Section 104 as for a guilty and wrongful evasion of surtaxes.

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* Dewing, in The Financial Policy of Corporations, 1934, page 606, says:

> "Many and varied considerations tend to influence the directors in determining the proportion of the total net surplus that may expediently be distributed among the shareholders and the proportion that should be kept in the business. This question is not one of the theory of accounts or of business law or even of universally applicable principles. It is purely one of individual business expediency."

At page 615, Dewing says:

> "The dividend disbursement is essentially a problem of business expediency and can be treated only in this light."

See Chapter 3, page 656, on The Practical Expediency of Dividend Disbursements.

(J) Respondent was no "pocketbook" for Kohl.

The Solicitor General's argument that Kohl by borrowing from the company used respondent as a convenient "pocketbook" for tax avoidance is refuted by several facts:

(1) For credit purposes the surplus was maintained intact. The cash was reduced, but the notes receivable account was increased by an equal amount (Ex. 6, R. 136).

(2) Such notes receivable were regarded as a good asset, collectable on demand (Field, R. 92).

(3) The Commissioner conceded them good by including the amount in his calculation of the surplus year by year (Ex. 5, R. 134).

(4) Every loan was entered on the books and evidenced by notes signed by Kohl (R. 81, 84).

(5) For the year ended Jan. 31, 1928 when Kohl's notes aggregated $424,100 (Ex. 6, R. 136) the Commissioner ruled (on Oct. 13, 1930, R. 125) that respondent was not subject to the penalty of Secs. 220, Act of 1926 and 104 of Act of 1928.

(6) Kohl repaid all the notes which he gave respondent during the year in question, and others besides as follows:

March 17, 1931	$60,000	
Aug. 25, 1932	$65,000	
May 24, 1933	$86,000	R. 142

The first of these payments was before the tax return was filed. The others were before the 60 day notice was mailed April 25, 1934 (Ex. 11, R. 142).

The corporate records show that subsequent to the date of the trial every loan with interest has been paid in full.

(7) If the Commissioner had honestly believed Kohl was using the Company as his "pocketbook" why did he not assess Kohl for taxes on the loans as though they were in fact dividends? He knew no fraud was involved in this matter in any respect whatsoever.

The element of loans by a corporation to a stockholder is not in any sense a fair test of a purpose to evade taxes.

Suppose a corporation is in the banking business, all of its stock being owned by one man. The business of a bank is to loan money. If the bank loaned money to its sole stockholder against his note, could it be said that because he borrowed from the bank which he owned, that thereby an intention was shown to use the corporation to evade taxes?

These loans were not handled in a way indicating tax avoidance. The manner they were handled shows clearly an intention to keep the money in the Corporation in accordance with the historic policy of expansion and business safety that had persisted for a quarter of a century.

In *United States* vs. *Tway Coal Sales Co.*, 75 Fed. (2d) 336, the taxpayer sued for the recovery of taxes paid after an assessment under Section 220 of the former law. Judgment for the taxpayer in the District Court was affirmed by the Circuit Court of Appeals (Sixth Circuit), despite the fact that the sole stockholder had borrowed larger sums both relatively and actually from his corporation than Kohl did from National Grocery Company.

Henry Kohl had learned through his early years of privation, and even starvation, the necessity of thrift. He

knew that National Grocery Company could not pay out its surplus and have it too. The Company could not have grown and expanded, as it did, if it had paid out its earnings in dividends.

This Corporation did no more than conduct its business according to the principles of thrift taught by Benjamin Franklin two centuries ago. An older precedent is the story of Joseph and Pharaoh, of the seven fat years and seven lean years. Genesis, Ch. 41. On such principles the outstanding business enterprises of this nation have been developed.

Is section 104 to be the death-knell of all progress except on borrowed money? If so, bankruptcy will catch all business when pay day comes in times of adversity.

POINT IV.

The words "gains and profits" as used in the statute mean actual, rather than taxable gains and profits.

No Court has so far determined the meaning of the words "gains and profits" as used in Section 104.

A.

The Commissioner and the Board of Tax Appeals below obviously considered the words "gains and profits," as used in Section 104, to mean taxable gains and profits, and in this, we submit, they erred.

> "It is undoubtedly the duty of the Court to ascertain the meaning of the legislature from the words used in the statute, and the subject matter to which it relates; and to restrain its operation within nar-

rower limits than its words import if the court are satisfied that the literal meaning of its language would extend to cases which the legislature never designed to embrace in it."

Chief Justice Taney in *Brewer* vs. *Blougher*, 39 U. S. 14 Pet. 178, 198;
Petri vs. *Commercial National Bank*, 142 U. S. 644; 650;
McKee vs. *U. S.*, 164 U. S. 287, 293.

There are at least three kinds of gains and profits: (1) Gains and profits as they are entered on the books of the corporation in its business operations; (2) actual gains and profits determined by market values of the assets of the corporation, and (3) gains and profits as determined by the provisions of the Revenue Acts and the regulations of the Commissioner of Internal Revenue.

The Commissioner and the Board paid no attention whatsoever to the uncontradicted proofs of the drastic declines in value of securities, inventories and real estate suffered by the respondent in the year under review. The extent of this depreciation is shown under Point B hereof. It is sufficient here to state that although respondent in its income tax return showed for the year under review it had total net income of $955,532.11, actually in the same year, because of the terrific depreciation in that, the first year of the depression, the Company's net worth shrank in value over $2,000,000.00.

Section 104(a) imposes the tax where a corporation permits its "gains and profits" to accumulate beyond the reasonable needs of the business. There must be both gains *and* profits before the tax falls.

Section 104 is the only place in the income tax law where the words "gains and profits" occur. All other sections of the income tax law impose taxes on income.

That "taxable" gains and profits could not have been meant by the Congress in enacting Section 104 would seem to be indicated by the fact that what are taxable gains and deductible losses for tax purposes is determined from time to time in the Revenue Acts enacted by the Congress. Surely a definition as variable as a March wind was not intended.

For instance, under the Revenue Act of 1934, Congress inserted a provision, Section 117(d), that if a corporation sells capital assets and incurs a net loss, only $2,000.00 of the amount thereof may be deducted from gross profits. Therefore, if a corporation, subject to the application of Section 102 of the 1934 Act, should sell, during a taxable year, stocks and bonds and have an actual loss therein of $2,000,000.00, and during the same year sell an apartment house and realize a profit thereon of $1,000,000.00, only $2,000.00 of the $1,000,000.00 net loss could be deducted. If the corporation also received an income of $500,000.00 from investments, it would have "taxable" gains and profits of $498,000.00, notwithstanding an actual loss of $500,000.00 from operations during the year.

If the words "gains and profits" as used in the statute are to be construed to mean taxable gains and profits (the method used by the Board below), the result might well amount to a confiscation of all the remaining assets of a corporation; whereas if actual gains and profits are considered no such devastating result would follow.

The words "gains and profits" as used in Section 104 are first found in the Tariff Act of October 3, 1913 (see

Appendix, p. 77); and they have been carried forward in each amendment passed since that time.

The only clue to the meaning of "gains and profits" as used in the Tariff Act of 1913, is contained in the words,

> "the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed or not, of all corporations * * * however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate" etc. (Appendix, p. 78).

Gains and profits are thus defined to mean the stockholder's share of the corporation's gains and profits for the year, *i. e.*—that portion which a corporation might properly distribute, or which a minority shareholder might by a court action compel to be distributed.

Suppose a corporation in the investment business with a capital of $2,000,000.00 in 1928 had invested $1,000,000.00 in an apartment house and $1,000,000.00 in bank stocks. Suppose that in 1930 the corporation had a net income from rents and dividends on the bank stocks amounting to $120,000.00, or six per cent on the capital. Suppose, furthermore, that in the depression the value of the apartment house had declined to $250,000.00, and the bank stocks to $250,000.00, the net worth of the assets of the company being $500,000.00. In such circumstances the capital of the business would actually be impaired by a million and a half, but the Commissioner of Internal Revenue would disregard the depreciation, as he did in the case under review, for he would contend that he is only concerned with losses estab-

lished through sales, and that the corporation having a net income of $120,000.00 and having declared no dividends is subject to the penalty of 50 per cent of $120,000.00, plus the normal tax on $120,000.00.

The New Jersey Corporation Act provides:

> "30. The directors of a corporation shall not make dividends except from its surplus, or from the net profits arising from the business of such corporation, nor shall it divide, withdraw, or in any way pay to the stockholders or any of them, any part of the capital stock of such corporation, or reduce its capital stock except as authorized by law; in case of any wilful or negligent violation of the provisions of this section, the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large upon the minutes of such directors at the time, or who not then being present, shall have caused their dissent therefrom to be so entered upon learning of such action, shall jointly and severally be liable at any time within six years after paying such dividend, to the stockholders of such corporation, severally and respectively, to the full amount of any loss sustained by such stockholders, or in case of insolvency to the corporation or its receiver to the full amount of any loss sustained by the corporation, by reason of such withdrawal, division, or reduction."
>
> P. L. 1904, Chap. 143, page 275.

Similar laws are in effect in most states. See *Corpus Juris*, Vol. 14, page 800.

Since Section 104 operates on the purposes, *i. e.*, mental processes of the board of directors of corporations, it is essential to consider the matters that necessarily guide

directors when they come to consider the declaration of dividends.

In times of depression directors necessarily must consider first, whether the assets of the corporation are actually worth book value; second, the effect on the business of a distribution of cash to the stockholders, and third, how long is the depression going to last, how far will it run, and what effect will it have on the business. These are only a few of the questions that are considered by careful business management.

Would any sensible director disregard a decline in market value of securities and other assets for the reason that the loss was not presently deductible in the computation of taxable net income?

It is a well known fact that during the depression the National Government, as well as State Governments, closed many banks because their securities had depreciated in market value to a point where their capital was excessively impaired, although the loss had not been actually realized in the sense that the securities had been sold.

How can directors properly perform their fiduciary obligation to stockholders if they must disregard actual business conditions and base their judgment solely on the provisions of the Revenue Acts, which are changed every year or so by the Congress?

Furthermore, this is a penal statute and as such should be strictly construed. It should be construed most favorably to the taxpayer and against the Government.

Gould vs. *Gould*, 245 U. S. 151;
Crocker vs. *Malley*, 249 U. S. 233;
United States vs. *Field*, 255 U. S. 262;

Smietanko vs. *First Trust Bk.*, 257 U. S. 606;
Schwab vs. *Doyle*, 258 U. S. 534;
United States vs. *Merriam*, 263 U. S. 188;
Hecht vs. *Malley*, 265 U. S. 156;
Reinecke vs. *Northern T. Co.*, 278 U. S. 348;
Aluminum Castings Co. vs. *Routzahn*, 282 U. S. 100;
Old Colony vs. *Commissioner*, 284 U. S. 561.

Certainly Congress never intended the penalty of 50 per cent to fall on a corporation whose net worth had an enormous shrinkage in the taxable year. It is essential to give their full meaning to the three words "gains and profits."

Congress did not use the word "gains" as synonymous with income or profits, for had that been its intention it would have used the words "income or profits." In using the word "gains" it undoubtedly contemplated unrealized capital increases or accession in the net worth of the business.

We submit that the proper construction of the words "gains and profits" is "income", plus increase in net worth. Undistributed net income is included in net worth necessarily. Where there is a terrific decrease in net worth how can there be any gains?

We shall now show that in fact the business had no gains for the year in question, for the net worth showed an enormous shrinkage, due entirely to the depression.

B.

The depreciation suffered by the Company in 1930 was greatly in excess of the net earnings reported in its income tax return.

The Company in its return reported income as follows:

Taxable net income (Sec. 13)	$863,787.22
Non-taxable income	90,858.40
Total net income under Section 104 (R. 13)	$954,645.62

Exhibit 15 (R. 146) shows that respondent suffered depreciation in securities for its fiscal year ended January 31, 1931, aggregating $943,517.42.

Mr. Ferguson (R. 93), Mr. Field (R. 87), and Mr. Armbruster (R. 96) testified that the local bank stocks should be eliminated from the statement because they were unsalable, had no liquidity, and could not be used as collateral for loans. In other words, the corporation could not raise money by selling them; and they had lost all their value for obtaining credit of borrowing money.

Therefore, the following securities must be eliminated from Exhibit 15 (R. 146), to see the true condition of respondent:

Commercial Trust Company of New Jersey	$ 768,240.00
*First National Bank of Jersey City	38,600.00
Hudson County National Bank	127,654.00
First National Bank of Hoboken	15,360.00
New Jersey Title Guarantee & Trust Company	60,288.00
Trust Company of New Jersey	58,480.00
Total	$1,068,622.00
Deducting from the market value of all securities 1/31/31	$2,125,434.50
The estimated value of the local bank stocks, as shown above	1,068,622.00
There remains a market value of all the securities in the portfolio of	$1,056,812.50
The book value of the Company's gross assets 1/31/30 was	$9,245,266.75
As of 1/31/31	9,108,437.14
**Decrease in year (Ex. 6, R. 136)	$ 136,829.61
Add depreciation in securities	943,517.42
Add book value of local bank stocks which had lost all value	1,068,622.00
***Shrinkage in values for year at least	$2,148,969.03

* It is true as the Solicitor General points out on page 24 of his brief that the company purchased 300 shares of this stock at $76.00 per share in 1930. But, Exhibit 23 (R. 162) indicates this purchase was made in August, when the price ranged from $90.00 to $75.00, but it had dropped to $50.00 by December.

** Miss Mullins estimated that the inventory had dropped in value between $200,000.00 and $250,000.00 (R. 81).

Mr. Gaddis estimated that the fair market value of the buildings, machinery and equipment had depreciated by $125,000.00 (R. 98).

*** We have not deducted anything for loss in book value of stocks in banks located outside Hudson County, where the Company's offices and warehouses are located, although the evidence of no value applies to them as well as the stocks of local banks.

Instead of a gain for the year the Company actually suffered a decrease in the value of its gross assets of over $2,000,000.00 (all the "profits" for the year on which it paid income taxes of $103,616.60, were included in the assets as of January 31, 1931, above mentioned, including the $103,616.60 income tax, which was not payable until April 15, 1931).

POINT V.

Respondent's gains and profits were not permitted to accumulate beyond the reasonable needs of the business.

There is not a word of testimony in this record from which an inference properly can be drawn that the capital and surplus were in excess of the reasonable needs of the business.

What are the reasonable needs of a business? It is obvious that a corporation owning one grocery store needs less capital than a corporation owning 815 stores. It would seem obvious at first glance that a corporation in the business of manufacturing automobiles, which produces one million cars a year, would require more capital than a competitor which manufactures a hundred thousand cars a year. Yet, the cost of building the hundred thousand might exceed the cost of producing the million which the first manufacturer produces. They may be hand-made, of finer quality and workmanship than the million cars. Or, two corporations just like respondent may be in the grocery business in different sections of the country. One corporation may own the real estate on which its 815 stores are located. The

other may rent its store locations. One may produce on its own farms its wheat, fruits and vegetables, manufacture its own flour, and can the fruits and vegetables. The other may buy in bulk and sell at retail. Do they both require the same capital? One of these supposititious corporations may cover with stores the entire area within trucking distance of its manufacturing plant. The other, like petitioner, may cover three-fourths of that area. They may both require the same capital; they may not.

The plans for the development of the one, economic conditions under its own peculiar situation, fears of flood or drought or anticipated labor troubles may require its management to conserve every possible cent of its gains and profits against the day of adversity. Only the management of the business can know of such matters and appreciate the perils they portend for the business.

When Section 104-B speaks of the reasonable needs of the business, what does it mean? The word "reasonable" shows an intention on the part of the Congress not to stagnate business but to permit business to grow and expand. Who can tell better than the management and its bankers what the reasonable capital needs of a business are? Theirs is the concern for the safety of the business; theirs the duty to finance it; theirs is the loss if the capital and surplus of the business are so depleted by dividends that bills cannot be paid at maturity and receivership ensues. If the business goes on and prospers and makes net earnings, then the greater the earnings the more the owners make and the more the Government receives in taxes. The mere fact that the surplus of a business is large does not, standing alone, prove that it is too large. This corporation has 100,000 customers per day (R. 83) visiting its stores, who

must be constantly supplied with food. The management is required always to have on hand available for distribution to these stores an adequate supply of merchandise. If war or famine should come, there is the necessity of careful management being in a position to buy instantly a supply of food for many months into the future (R. 72).

Mere size of a surplus cannot determine the "reasonable needs of the business", for while a surplus of $9,000,000 would be wholly disproportionate to one grocery store doing a business of $50,000 a year, it would be wholly inadequate for the Ford Motor Company doing a business of hundreds of millions of dollars per year. Yet, the Solicitor General contends that the Circuit Court of Appeals erred when it found from an examination of this record that there was no evidence, substantial or otherwise, to support its finding. How could the Court of Appeals have found otherwise when not a witness testified either that the surplus, though large, was too large, or that the purpose of the management was different from what the management testified under oath?

Reasonable needs of a business include many factors, such as, proper working capital, proper reserves for contingencies foreseeable and unforeseeable, droughts, floods, wars, labor disputes, lack of products, depressions and recessions, and reserves for proper growth and expansion of the business.

The Solicitor General, in his brief (p. 23) chides the Court below because it stated the respondent had a right to provide surplus to aid it in case of fires, earthquakes, floods, wars, strikes, boycotts and other contingencies, and states that no witness stated that earthquakes, floods, etc. were probable in New Jersey, but such contingencies were real and entirely probable.

Since 1930 a vast world-wide depression has occurred, bringing ruin to many long established and apparently financially sound institutions. Great floods came and great droughts occurred, covering large areas of farm lands, causing scarcity of food products; wars have come (not here in America, but on the other side of the world), of so great an extent as to cause great unrest and uncertainty among nations; great labor unrest has come about; strikes and boycotts have occurred, throwing many thousands of men out of work; demands of labor for shorter hours and higher wages have come about, requiring greater expenditures in wages and employment of more men; a great recession now exists.

All of the foregoing the wise business man foresees, or tries to foresee, and provides against.

Provision for such eventualities is provision for the reasonable needs of the business.

We submit that the words "reasonable needs of the business" were obviously used by Congress for the purpose of giving wide latitude to the management of business; they indicate no intention of preventing business from growing. They mean not the needs of the moment, but were purposely intended to give conservative executives the latitude which prudent business men need in the conduct of their affairs.

If the Board of Tax Appeals could properly and lawfully find from a mere inspection of the balance sheets and other documents in evidence in this case, that the surplus of National Grocery Company was beyond the reasonable needs of the business, it must follow that sworn testimony has lost its place in judicial proceedings and there need be no further provisions in the law for appeals from administrative Boards.

Every business must have capital. Even the newsboy in the street must have a few pennies with which to buy the papers he sells. The mere fact that a large business has large capital cannot in the essence of things, standing alone, prove that it is too large. The surplus of this business was invested in warehouses, an office building, stores, trucks, merchandise, and a part in cash and securities. The gross sales for the year under review were over $25,000,000 or nearly three times the gross assets of the business and from six to eight times the working capital.

Since there was no proof whatever before the Board either that the surplus of this business was in excess of its reasonable requirements or that the directors were actuated by the forbidden purpose, the Circuit Court of Appeals did not err in reversing the determination of the Board.

POINT VI.

Section 104 is not a tax on income; it is a direct tax on a purpose, or state of mind; hence void.

"Purpose" is defined to be:

> "That which one set before himself as an object to be attained; the end or aim to be kept in view in any plan, measure, exertion, or object; design; intention; the object, effect, or result aimed at, intended, or attained; as energy applied to little purpose."
>
> *Webster's New International Dictionary.*

The most careful analysis leads to the inevitable conclusion that this section is nothing less than an attempt to levy a tax or penalty upon a state of mind. It is not a

duty, impost or excise. It is not a tax on income. Although the tax is measured by income, it is not the receipt of income which is taxed. The receipt of income is not the event or circumstance which provokes or authorizes the imposition of the tax, nor is the mere retention of income in the form of surplus the circumstance or event which is taxable. The mere retention of income is not an act or an event and hence cannot be the subject of an excise tax. Indeed, it must be self-evident that a tax upon the mere retention and accumulation of income in the form of a corporate surplus would not be an *income* tax within the meaning of the 16th amendment. The tax is, therefore, imposed upon a mere purpose or intention. It is an attempted direct penalty upon the assets of a corporation because the majority of the board of directors have a design to avoid paying surtaxes on income of the shareholders that would be levied if they took certain action which they refrain from taking—namely declaring and paying dividends.

The tax sought to be imposed by Section 104 rests solely upon a classification premised upon a state of mind and without relation to tax avoidance *ipso facto*, and without respect as to whether the purpose condemned ever becomes a matter of accomplishment. As was said in *United Business Corporation* vs. *Commissioner*, 19 B. T. A. 809.

> "The emphasis of the statute is placed upon the purpose and if this purpose clearly appears the corporation is subject to the tax whether the accumulations be large or small."

And again said the Board of Tax Appeals in *Cecil B. DeMille* vs. *Commissioner*, 31 B. T. A. 1161;

> "But the taxes under these statutory provisions are not imposed because of effects; avoidance *per se* is not prohibited. It is the *purpose*, the intention

> motivating a course of conduct which is made controlling by the very words of the statute."

The Courts have said that this is:

> "A statute which stands on the footing of the participants' state of mind * * * the test remains the state of mind itself, * * *" *United Business Corporation* vs. *Commissioner,* 62 Fed. (2d) 754.

A statute undertaking a classification based upon nothing more than a mere intention, and without respect or regard to ultimate execution of that intention does violence to the fundamental principles of jurisprudence that a mere state of mind, however vicious it may be, but without more, is a matter beyond the ambit of temporal jurisdiction.

4 Blackstone Comm., p. 21.

And where the Government is defrauded of its revenues or where an attempt to so defraud is made, the law punishes the act or the attempt, but not the *intention* to defraud.

U. S. vs. *Riddle,* 5 Cranch. 311.

See also, *Chisholm* vs. *Commissioner,* 79 Fed. (2d), 14, where it is said,

> "It is important to observe just what the Supreme Court held in that case (Gregory *vs.* Helvering, 293 U. S. 465). It was solicitous to reaffirm the doctrine that *a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it.* It is true that that Court has at times shown itself indisposed to assist such efforts. * * *, *but it has never, so far as we can find, made that purpose the basis of liability; and it has often said that it could not be such.*"
>
> (Parenthesis and italics supplied.)

Nor is the classification undertaken to be made by Section 104 based upon any principle elsewhere condemned by law.

> "The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them by legal means which the law permits cannot be doubted."
>
> *Gregory* vs. *Helvering*, 293 U. S. 465.

> "A purpose to minimize or avoid taxation is not an illicit motive."
>
> *Sawtell* vs. *Commissioner*, 82 Fed. (2d) 221.

> "There was nothing unlawful or even mildly unethical in the motive of petitioner to avoid some portion of the burden of taxation."
>
> *Marshall* vs. *Commissioner*, 57 Fed. (2d) 633.

> "Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes."
>
> *Helvering* vs. *Gregory*, 69 Fed. 2d. 809.

> "The purpose to save income taxes is now legally above reproach."
>
> *Rands Inc.* vs. *Commissioner*, 34 B. T. A. 1094, 1106.

See also, *Sawtell* vs. *Commissioner*, 82 Fed. 2d. 221, *Commissioner* vs. *Eldridge*, 79 Fed. 2d. 629 and *Jones* vs. *Helvering*, 71 Fed. 2d. 214, 217.

In *Superior Oil Co.* vs. *Mississippi*, 280 U. S. 390, 395, Mr. Justice Holmes stated:

> "The fact that it (the appellant) desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you intentionally may go as close to it as you can, if you do not pass it."

To the same effect, Mr. Justice Holmes said in *Bullen* vs. *Wisconsin*, 240 U. S. 625, 630:

> "* * * We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law."

If a corporation permits its gains and profits to accumulate *without* a purpose to prevent the imposition of a surtax upon its stockholders, the corporation is on the safe side of the line drawn by the law notwithstanding the fact that the surtax is thereby avoided. If, on the other hand, a corporation permits its gains and profits to accumulate *with* a purpose to prevent the imposition of the surtax upon its stockholders, section 104 attempts to put the corporation on the wrong side of the line drawn by the law. It is submitted that in substance, purpose and effect section 104 is tax on a *purpose* to stay on the safe side of the line which the law has drawn.

If tax avoidance, *ipso facto*, cannot be the basis for liability, irresistible logic constrains a rule that a classification for tax based on nothing more than a purpose to effect avoidance is so clearly without reasonable ground for support and so patently unnatural that the tax sought to be

imposed is void as a direct tax not levied in proportion to the population, and also in conflict with the due process clause of the Fifth Amendment.

POINT VII.

Section 104 is not a tax on income within the meaning of the Sixteenth Amendment, but is a penalty designed to force corporations lawfully formed under State laws to distribute their earnings in order to create a basis for taxation against the stockholders, hence is void.

Vice President Garner when a member of the Ways and Means Committee of the House of Representatives, in explaining Section 104 to the House, said:

> "Section 104 is entirely new. It is inserted in the bill in response to the Advisory Committee's criticism of the administration of Section 220 in the present law. I am sure you will remember what Section 220 in the present law is. It was intended to enable the Secretary of the Treasury to force corporations to distribute their profits and subject their shareholders to the tax levied by Congress. It has been in the statute for some years" (Appendix, p. 101).

In the debate in the House on the section Mr. Green of Iowa said:

> "You will not find much direct revenue raised by this provision but the effect will be to dissolve a number of these corporations that were formed to escape the surtax, and the persons who own them will pay their surtax in the regular way, the same as other people. That will be the effect. * * *

> I am told by gentlemen familiar with the operations of these corporations and gentlemen connected with large accounting firms and others that Section 220 of the present law, while it never brought in any revenue, operated in such a way as to cause a great many of these corporations to dissolve. It has been, in fact, a most excellent scarecrow, if it has been nothing else, and it has driven these people into taking such action as to avoid the penalties prescribed" (Congressional Record—House, p. 520, December 12, 1927). (Appendix, p. 101.)

The constitutionality of section 220 as applied to an operating company was seriously questioned by Mr. Gregg and by Senator Jones on the hearings before a Select Committee on investigation of the Bureau of Internal Revenue, Sixty-Eighth Congress (Appendix, pp. 94, 95).

It seems to have been conceded that the section had no force or effect against a corporation in a mercantile or industrial business (Secretary Mellon, Appendix, p. 84; Representative Jones, Appendix, p. 85; Mr. Manson, Appendix, p. 91).

The Sixteenth Amendment is as follows:

> "The Congress shall have power to lay and collect taxes on income, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The Amendment was declared effective in a Proclamation dated February 25, 1913.

In determining whether the penalty attempted to be imposed by Section 104 of the Revenue Act of 1928, is a tax on income within the meaning of the Sixteenth Amendment, an examination of the revenue laws is important.

Section 13 of the Revenue Act of 1928, provides:

> "There shall be levied, collected, and paid for each taxable year upon the net income of every corporation, a tax of 12 per centum of the amount of the net income in excess of the credits against net income provided in Section 26."

Section 26 states:

> "For the purpose only of the tax imposed by section 13 there shall be allowed the following credits:
>
> (a) The amount received as interest upon obligations of the United States which is included in gross income under section 22; and
>
> (b) In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $3,000; but if the net income is more than $25,000 the tax imposed by section 13 shall not exceed the tax which would be payable if the $3,000 credit were allowed, plus the amount of the net income in excess of $25,000."

Unquestionably Section 13 properly levied an income tax upon the net income of every corporation in the United States.

The provisions of the Income Tax Law imposing taxes upon individuals are Sections 11 and 12.

Section 11 provides for a normal tax on individuals equal to the sum of the following:

> "(a) 1½ per centum of the first $4,000 of the amount of the net income in excess of the credits against net income provided in section 25;
>
> (b) 3 per centum of the next $4,000 of such excess amount; and

(c) 5 per centum of the remainder of such excess amount."

Section 12 provides that there shall be levied, collected, and paid for each taxable year upon the net income of every individual a surtax as specified in the section.

It is clear that the purpose of Section 104 was twofold: (first) to force the distribution of corporate earnings to stockholders in order to increase the income of stockholders, to the end that more surtaxes might be levied than otherwise; and, (second) heavily to penalize corporations that did not distribute their earnings in the form of dividends.

That this section as it operates upon respondent is a penalty cannot be doubted.

The leading case construing such a penalty is *Helwig* vs. *United States,* 188 U. S., 605. The Tariff Act of 1890 imposed an *ad valorem* duty of ten per centum on the importation of wood pulp. Section 7 provided that if the importer should not declare the value correctly, and that if the appraised value exceeded by more than ten per centum the value declared in the entry, there should be levied, collected and paid, in addition to the duties imposed by law, a further sum equal to two per centum of the total appraised value for each one per centum that such appraised value exceeded the value declared, and that if such appraised value shall exceed the value declared in the entry more than forty per centum, such entry may be held to be presumptively fraudulent. The declared value of this importation was $13,252, and the duty of $1,325 was paid. The merchandise was later appraised at $16,792, and a penalty was assessed against the importer of $9,067, and suit brought therefor against the importer in the United

States Circuit Court in New York. The case was tried on an agreed state of facts, and motion was made to dismiss and for judgment for defendant on the ground the action was to recover a penalty or penalties arising under the customs laws and that the Circuit Court had no jurisdiction.

Mr. Justice Peckham, speaking for this Court, said (p. 613):

> "Although the sum imposed by reason of undervaluation may be simply described as 'a further sum' or 'an additional duty,' if it is yet so enormously in excess of the greatest amount of regular duty ever imposed upon an article of the same nature, and it is imposed by reason of the action of the importer, such facts clearly show it is a penalty in its intrinsic nature, and the failure of the statute to designate it as a penalty, but describing it as 'a further sum,' or 'an additional duty,' will not work a statutory alteration of the nature of the imposition, and it will be regarded as a penalty when by its very nature it is a penalty. It is impossible, judging simply from its language, to hold this provision to be other than penal in its nature." • • •
>
> The judgment was reversed.

Convincing proof that Section 104 imposes a penalty is afforded by Section 293(b) of the Revenue Act of 1928, which reads:

> "If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in Section 3176 of the Revised Statutes, as amended."

See also Sec. 293(a) which provides a penalty of 5% for negligence.

In other words, the penalty imposed upon a fraud-doer under the Act of 1928 is 50 per centum *of the tax,* whereas the penalty under Section 104 of the same Act is 50 per centum *of the income,* including dividends and income from tax exempt securities,—a much more severe penalty than for a fraud.

In the *Child Labor Tax* case, 259 U. S. 34, Chief Justice Taft said:

> "Grant the validity of this law, and all that Congress would need to do hereafter, in seeking to take over to its control any one of the great number of subjects of public interest, jurisdiction of which the states have never parted with, and which are reserved to them by the 10th Amendment, would be to enact a detailed measure of complete regulation of the subject and enforce it by a so-called tax upon departures from it. To give such magic to the word 'tax' would be to break down all constitutional limitation of the powers of Congress and completely wipe out the sovereignty of the states.
>
> The difference between a tax and a penalty is sometimes difficult to define, and yet the consequences of the distinction in the required method of their collection often are important. Where the sovereign enacting the law has power to impose both tax and penalty, the difference between revenue production and mere regulation may be immaterial; but not so when one sovereign can impose a tax only, and the power of regulation rests in another. Taxes are occasionally imposed in the discretion of the legislature on proper subjects with the primary motive of obtaining revenue from them, and with the incidental motive of discouraging them by making their continuance onerous. They do not lose their character as taxes because of the incidental

motive. *But there comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such* and becomes a mere penalty, with the *characteristics of regulation and punishment.* Such is the case in the law before us. Although Congress does not invalidate the contract of employment, or expressly declare that the employment within the mentioned ages is illegal, it does exhibit its intent practically to achieve the latter result by adopting the criteria of wrongdoing, and imposing its principal consequence on those who transgress its standard."

Hill vs. *Wallace,* 259 U. S., 44;
Hammer vs. *Dagenhart,* 247 U. S., 251.

Chief Justice Marshall in *M'Culloch* vs. *Maryland,* 4 Wheat., 316, said:

> "Should Congress, in the execution of its powers, adopt measures which are prohibited by the Constitution, or should Congress, under the pretext of executing its powers, pass laws for the accomplishment of objects not intrusted to the government, it would become the painful duty of this tribunal, should a case requiring such a decision come before it, to say that such an act was not the law of the land."

The declared object of the Narcotic Law is to provide revenue, and the Supreme Court has held that "whatever additional moral end it may have in view must be reached only through a revenue measure and within the limits of a revenue measure."

United States vs. *Jin Fuey Moy,* 241 U. S., 394.

The Court said in *Linder* v. *U. S.,* 268 U. S. 5:

> "Congress cannot, under the pretext of executing delegated power, pass laws for the accomplishment of objects not intrusted to the Federal government. And we accept as established doctrine that any provision of an act of Congress ostensibly enacted under power granted by the Constitution, not naturally and reasonably adapted to the effective exercise of such power, but solely to the achievement of something plainly within power reserved to the states, is invalid, and cannot be enforced."

In *United States* vs. *Butler,* 297 U. S., 1, Mr. Justice Roberts said at page 74:

> "Congress has no power to enforce its commands on the farmer to the ends sought by the Agricultural Adjustment Act. It must follow that it may not indirectly accomplish those ends by taxing and spending to purchase compliance. The Constitution and the entire plan of our government negative any such use of the power to tax and to spend as the act undertakes to authorize. • • • If, in lieu of compulsory regulation of subjects within the states' reserved jurisdiction, which is prohibited, the Congress could invoke the taxing and spending power as a means to accomplish the same end, clause 1 of section 8 of Article I would become the instrument for total subversion of the governmental powers reserved to the individual states."

In the bituminous coal case, *Carter* vs. *Carter Coal Co.,* 298 U. S., 238, Mr. Justice Sutherland said, that the so-called excise tax of 15 per centum on the sale price of coal at the mine, or, in the case of captive coal and return the fair market value, with its drawback allowance of 13½%, is clearly not a tax but a penalty. He added:

> "It is very clear that the 'excise tax' is not imposed for revenue but exacted as a penalty to compel compliance with the regulatory provisions of the act. The whole purpose of the exaction is to coerce what is called an agreement—which, of course, it is not, for it lacks the essential element of consent. One who does a thing in order to avoid a monetary penalty does not agree; he yields to compulsion precisely the same as though he did so to avoid a term in jail.
>
> The exaction here is a penalty and not a tax within the test laid down by this court in numerous cases" (citing them).

If it should be contended that Section 104 was not designed to operate as a compulsion against corporations, but merely gave them a choice, and that they could avoid the penalty by declaring dividends, a complete answer is given by this Court in *Frost & F. Trucking Co.* vs. *Railroad Commission*, 270 U. S., 583, 593, where it is said:

> "In reality, the carrier is given no choice, except a choice between the rock and the whirlpool,—an option to forego a privilege which may be vital to his livelihood, or to submit to a requirement which may constitute an intolerable burden."

Section 104 cannot be sustained as a necessary aid to the effective *enforcement* of the law imposing surtaxes on individuals, for the reason that, as applied to a *bona fide* operating company, the obvious purpose and effect of the section is not to prevent *evasion* of personal surtaxes, but is, on the contrary, to control and regulate the dividend policy of domestic corporations so that income not otherwise existing or taxable under the revenue laws and under

the constitution, may be created and be subjected to taxation.

Where a man who has been in receipt of a taxable income of a million dollars a year from stocks and bonds, transfers those securities to a corporation after a personal surtax law has been enacted, it may well be said that his action constitutes evasion of the tax law. Such conduct is in the nature of a fraudulent conveyance; and it may well be argued that Congress has power to tax that individual or his corporation in the same manner as if such transfer had never been made.

Indeed, in the early income tax laws Congress proceeded on this theory and imposed a tax, without penalty, on the individual shareholder rather than on the corporation to which such a transfer had been made. (Tariff Act of 1913, Appendix, p. 78; Revenue Act of 1916, Appendix, p. 79; Revenue Act of 1919, Appendix, p. 80.) In the Revenue Act of 1921, however, and as a result of the decision of this Court in *Eisner* vs. *McComber*, 252 U. S. 189, this provision was changed and Congress provided for a penalty on the corporation instead of a tax on the individual shareholder (Revenue Act of 1921, Appendix, p. 81; Report of the Committee on Ways and Means, 1921, Appendix, p. 82).

As applied to an operating company formed before the Sixteenth Amendment was adopted Section 220 of the Revenue Act of 1921 and all of its successor sections, including Section 104 of the Revenue Act of 1928, clearly had no other purpose than by the use of an arbitrary penalty, to *create* a basis for taxation where none otherwise existed. Statement by Garner (M. C.) (Appendix, p. 101).

Congress might, with greater justification, have provided that any citizen who permits his money to remain invested in tax exempt bonds and obligations of the several states and subdivisions thereof, for the purpose of preventing the imposition of the surtax, shall be subject to a tax equal to 50 per cent of his net income as reported, which shall be in addition to the tax otherwise imposed. There is no difference in principle between Section 104 as applied to respondent and the use of a penalty to prevent a citizen from investing in or keeping his funds invested in tax exempt securities.

POINT VIII.

Section 104 improperly invades the domain reserved to the States by the Tenth Amendment.

As to corporations *formed* by rich men for the purpose of avoiding the imposition of the surtax, Section 104 of the Revenue Act of 1928 and Section 220 of the earlier Revenue Acts has been held valid and enforceable.

United Business Corporation vs. *Commissioner*, 62 Fed. (2d) 754; certiorari denied 290 U. S. 635;

Williams Inv. Co. vs. *United States*, 3 F. Supp. 225;

Saenger, A. D., Inc. vs. *Commissioner*, 84 Fed. (2d) 23; certiorari denied, 299 U. S. 577;

Almours Securities vs. *Commissioner*, 91 F. (2d) 427; certiorari denied January 10, 1938.

As to such corporations expressly formed for the sole purpose of tax avoidance, Congress has the power to im-

pose the income tax, and may have the power to penalize the transaction as a fraud against the revenues.

But as to corporations like respondent, formed long before the income tax laws were passed, and which were engaged in *bona fide* business operations, Congress has power to impose an income tax, but has no power to regulate their internal affairs.

The act may be valid as to the one and invalid as to the other.

Nashville, C. & St. L. R. Co. vs. *Walters,* 294 U. S. 405;

Champlin Ref. Co. vs. *Corporation Commission,* 286 U. S. 210.

Congress, for instance, has no power to provide what the corporate powers of a corporation may be; or under what conditions a corporation formed under the laws of a State may operate; or how large a capital it shall have and into what number of shares and of what par value it may be divided; it cannot regulate how much of the capital of such a corporation must be paid in, nor what the duration of the charter may be. Such matters are reserved to the States by the Tenth Amendment.

All of the States have laws providing for the incorporation of corporations. The States tax such corporations for their own benefit. If Congress may compel the distribution of the earnings of a *bona fide* business corporation by this law, then by like penalties it may regulate all of the internal affairs of corporations.

By like method it can regulate the affairs of every citizen and taxpayer in the nation.

If Congress may impose this penalty, then it may impose a like penalty on a corporation that has a capital in

excess of a given amount; or has a surplus beyond a certain amount. If this law is valid Congress may limit the number of employees a corporation may have; it may limit the kind and amount of business transacted; the area in which it may transact business; the wages paid; the salaries of officers and directors; the size and location of offices, warehouses, factories and every detail of the business.

If this law is valid what is there to prevent Congress putting a like penalty on any citizen who makes a contribution for the erection of a synagogue or a church, or who contributes to foreign or home missions, or who contributes moneys for the support of any political party?

As Chief Justice Taft said in the *Child Labor Tax* case, 259 U. S. 34,

> "there comes a time in the extension of the penalizing features of the so-called tax when it loses its character as such and becomes a mere penalty, with the characteristics of regulation and punishment."

As to corporations formed for the express purpose of tax avoidance, Congress has the power to impose an income tax and may have the power to penalize the transaction as a fraud against the revenues, but as to corporations formed for *bona fide* business purposes, Congress has the power to tax, but the States have the power to regulate. Our form of government requires that each shall be confined to its own domain.

The National Grocery Company under the regulations of the State of New Jersey grew from a corporation of insignificant size, operating three stores, to a large and successful corporation in 1930, operating 815 stores, with sales of merchandise amounting to over $25,000,000.00. It owned

and operated in connection with its merchandising business, administrative offices, warehouses, manufacturing plants and apparatus, stables and garages, a large bakery, extensive delivery equipment, store fixtures and furniture, and a miscellaneous stock of merchandise contained in its retail stores and distributing warehouses, on which it paid local taxes.

In twenty-two years its employees grew from a handful to 2,332. It paid local and State taxes for the year under review of $36,371.87 (Ex. 4, R. 133). By consistently pursuing the policy that the management had adopted at the inception of the business of ploughing the earnings back into the business, the Company year by year grew larger and stronger. Each year as its property increased, its taxes increased; as its business increased, the number of its employees and the amount of its purchases of goods and merchandise increased. It is obvious that as this business grew and prospered, it became far more important to the public than to its individual owner, for while the benefit to him in the form of net earnings was large, nevertheless the benefit to the public was far greater, in the purchase of materials of all kinds, the payment of rents and taxes, and the wages of 2,332 employees.

This corporation was organized under the provisions of the New Jersey Corporation Act. That Act, as amended (P. L. 1926, page 541, Section 47), permits corporations to regulate the whole matter of the distribution of profits by dividends to stockholders.

> "47. Unless otherwise provided in the original or amended certificate of incorporation, or in a by-law adopted by a vote of at least a majority of the stockholders, the directors of every corporation or-

ganized under this act shall have power in their discretion from time to time to fix and to vary the amount of the working capital of the corporation and to determine, what, if any, dividends shall be declared and paid to stockholders out of its surplus or net profits. Dividends may be declared and paid in capital stock with or without par value.

"If so provided in its certificate of incorporation or in an amendment thereof, every corporation organized under this act shall have the power to create a sinking fund of a specified amount or proportion of its net profits for the purchase, retirement or redemption of any class or classes of preferred stock and to apply such sinking fund to such purpose."

P. L. 1926, Chap. 318, p. 541.

Until a dividend is declared the entire assets of the corporation, including surplus or accumulated profits in whatever form they exist, belong to the corporation, and the corporation owes no debt in respect thereto to the stockholders as individuals.

See

Stevens vs. *United States Steel Corporation,* 68 N. J. Eq., 373.

The rule in every jurisdiction is that the determination of the dividend fund, which always calls for a determination of the part or amount of profits to be retained or surplus to be accumulated, rests in the practically unfettered discretion of the board of directors, and the exercise of that discretion will never be set aside by the courts unless and until it is clearly and convincingly shown to have been exercised for a purpose foreign to the accomplishment of the

objects of the corporation; that is to say, to benefit a particular shareholder or group to the disadvantage of others, or to prejudice or "freeze out" a particular shareholder, or to embark upon a venture not within the corporate powers.

Neither the courts nor the Commissioner can displace the board of directors and substitute their judgment for that of the board in the absence of clear proof of unlawful exercise of power.

United States vs. *Philadelphia Knitting Mills*, 273 Fed. 657.

The exercise of directors' discretion turns on business expediency and not on strict necessity or rules of law—not on the whims or predilections of the Commissioner.

The Courts have repeatedly held that the discretion of directors in declaring dividends cannot be controlled or revised by courts unless it is made to appear clearly and convincingly that their acts were fraudulent or collusive or destructive of the rights of shareholders.

New York, Lake Erie & Western Railroad v. *Nickals*, 119 U. S. 296 (1886);

Gibbons v. *Mahon*, 136 U. S. 549 (1890);

State of Missouri, ex rel. Southwestern Bell Telephone Co. v. *Public Service Commission*, 262 U. S. 276 (1923);

Federal: Wilson v. *American Ice Co.*, 206 Fed. 736 (D. C., N. J., 1913);

New Jersey: Park v. *Grant Locomotive Works*, 40 N. J. Eq. 114 (1885), affirmed 45 N. J. Eq. 244;

Raynolds vs. *Diamond Mills Paper Co.*, 69 N. J. Eq. 299 (1905);

Blanchard vs. *Prudential Insurance Co.*, 80 N. J. Eq. 209 (1912);
Murray v. *Beattie Mfg. Co.*, 79 N. J. Eq. 604 (1912);
Levitan v. *North Jersey Holding Co.*, 106 N. J. Eq. 517 (1930);
Auburn Button Works vs. *Perryman Electric Co., Inc.*, 107 N. J. Eq. 554 (1931);
Madsen v. *Burns*, 108 N. J. Eq. 275 (1931);
Shonnard v. *Elevator Supplies Co., Inc.*, 111 N. J. Eq. 94 (1932);
Ace Bus Transportation Co. v. *So. Hudson County Boulevard Bus Owners' Association*, 118 N. J. Eq. 31 (1935);

Congress never intended that Section 104 should be extended as the Commissioner has attempted to extend it in this instance.

As Mr. Manson said in testifying before the Select Committee in 1925, this section, as applied to manufacturing companies and things of that sort, has no force or effect whatever (Appendix, p. 96).

Secretary Mellon testified before the Committee on Finance of the Senate April 3, 1924, that as to corporations that are organized to carry on business, that are developing the business, "there is a growth to the business, and that Section 220 does not apply to them" (Appendix, p. 85).

Clearly, as applied to corporations in active business, formed, existing and regulated by the laws of the States and not formed for the purpose of tax avoidance, Section 104 is unconstitutional as in conflict with the 10th Amendment.

POINT IX.

Section 104 of the Revenue Act of 1928 as applied to respondent deprives it of its property without due process of law, and is void as in conflict with the Fifth Amendment.

Section 104 is unreasonable, arbitrary and capricious in the following respects:

(1) Directors cannot tell from a study of Section 104 how to avoid the penalty for these reasons:

(a) There is no standard or gauge whereby they can tell what relation there may properly be between capital and surplus on the one hand and volume of business done on the other;

(b) no standard is set up by the Act showing what reserves may properly be set up by the directors for expansion of the business, for obsolescence of plant and machinery, for unusual depreciation caused by depressions and recessions, and for losses due to strikes, walkouts, fire, flood, holdups, thefts, embezzlements, drought, famine, and other perils that business must anticipate;

(c) the statute sets up no standard as to the amount of dividends that must be paid by a corporation to avoid the penalty, either as to amount of dividends, or as to the proportion of reported net earnings that must be declared and paid as dividends.

(2) No standard or formula is specified in the statute according to which the Commissioner of Internal Revenue must apply the penalty; each Commissioner will necessarily follow his own prejudices and predilictions.

(3) No standard or formula is specified in the statute whereby the directors of a corporation may know when and under what circumstances the penalty will be enforced by the Commissioner.

(4) The minority of the stockholders and directors may try unsuccessfully to force the payment of dividends. The majority may refuse to pay dividends. Yet this penalty falls alike on the property of both, although the minority not only have no intention of avoiding the surtax, but even tried unsuccessfully to have dividends declared that would subject them to the imposition of the surtax.

(5) The penalty may be imposed at the discretion, or mere whim of the Commissioner of Internal Revenue.

(6) Directors necessarily make their decision as to the advisibility of paying dividends in the light of present conditions. The determination of the Commissioner to assess the penalty cannot be made until after the tax return is filed, and may not be made until several years after the end of the taxable year (in this case it was three years afterward (R. 11)). The Commissioner has the benefit of hindsight, and necessarily acts from a substantially different base than the directors. The penalty is assessed retroactively and bears interest from the date the income tax for the year was payable, hence is in fact a greater penalty than is specified in the statute.

(7) The penalty bears no relation whatever in amount to surtaxes avoided.

(8) The penalty being enforceable within the arbitrary and uncontrolled discretion of the Commissioner of Internal Revenue in an amount five times the amount of the income tax, and several

> times the amount of the penalty prescribed by statute for fraud on the revenues, is an instrument of oppression and imposition without parallel in the revenue laws.

As to corporations in active mercantile and manufacturing businesses, using all their ingenuity and abilities to grow and expand, trying to give as much employment as possible, to manufacture, buy and sell as much goods as possible, and ready and willing to pay all proper taxes on the income of their labor and the fruits of their capital, this penalty is nothing less than a confiscation of property.

If there are two or more corporations of equal size, doing the same business and the same volume of business, the Commissioner may levy the penalty on one and not on the other. The directors of neither corporation can tell when the penalty will be levied until the ninety day notice is received. Or, the Commissioner may assess the penalty against neither.

In this case the income tax return was filed April 15, 1931. The sixty day notice of the imposition of the penalty was mailed April 25, 1934 (R. 11). Therefore before the penalty was assessed interest of $85,924.92 had accumulated (6% × 3 years × $477,360.68). When levied the penalty was not 50 per cent of the net profits as the statute provides, but 50 per cent plus 18 per cent.

This Court has recognized that a statute purporting to tax may be so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment.

> *Brushaber* vs. *Union Pacific R. Co.*, 240 U. S. 1;
> *Barclay & Co.* vs. *Edwards*, 267 U. S. 442;
> *Nichols* vs. *Coolidge*, 274 U. S. 531.

Mr. Justice Sutherland in *Connally* vs. *General Construction Co.*, 269 U. S. 385, 391, said:

> "That the terms of a penal statute creating a new offense must be sufficiently explicit to inform those who are subject to it what conduct on their part will render them liable to its penalties, is a well recognized requirement, consonant alike with ordinary notions of fair play and the settled rules of law. And as a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates the first essential of due process of law. International Harvester Co. *v.* Kentucky, 234 U. S. 216, 221; Collins *v.* Kentucky, 234 U. S. 634, 638."

Yu Cong Eng vs. *Trindad*, 271 U. S. 500;
Nebbia vs. *New York*, 291 U. S. 502;
United States vs. *Cohen Grocery Co.*, 255 U. S. 81.

POINT X.

Section 104 of the Revenue Act of 1928 is null and void because it reposes legislative power in the Commissioner of Internal Revenue, contrary to the letter and spirit of Article I, Section 1, and Article I, Section 8, par. 18 of the Constitution.

Article I, Section 1 of the Constitution provides:

> "All legislative powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives."

Article I, Section 8, Par. 18 provides that:

> "The Congress shall have power to make all laws which may be necessary and proper for carrying into execution the foregoing powers, and all other powers vested by this Constitution in the Government of the United States, or in any Department or officer thereof."

Section 104 (a) operates when a corporation is "availed of for the purpose of preventing the imposition of the surtax upon its stockholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed", and (b) provides that the fact that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

Paragraph (a) is not applicable in the absence of a purpose to prevent the imposition of the surtax. But the law does not specify how the purpose is to be ascertained. The penalty necessarily operates upon the mental processes of the directors of a corporation. No standard is set up for the determination of the purpose beyond section (b), which reposes in the Commissioner of Internal Revenue the duty to determine whether gains or profits are permitted to accumulate beyond the reasonable needs of the business. Congress has not set up any standard by which the Commissioner shall determine what are the reasonable needs of a business.

When Congress provided a tax on the net income of corporations under Section 13 of the Revenue Act, it adopted a standard and provided for a tax of twelve per cent upon the amount of net income in excess of certain defined credits against net income.

When Congress, however, enacted Section 104 of the Revenue Act it imposed the penalty not by any standard that was known to the general public, including the officers and directors of corporations, but it left the standard of what capital was required for the reasonable needs of the business solely to the discretion of the Commissioner of Internal Revenue. One Commissioner necessarily would have one standard and another a different standard. See Senator Smoot's statement (Appendix, p. 102).

Since Section 104 first appeared in the Tax Act of 1913, and no similar case has heretofore reached the Board of Tax Appeals or any Court, it is apparent that none of the Commissioners heretofore have attempted to collect the tax from *bona fide* business corporations needing capital for their very existence.

We submit this case is controlled by the following decisions of this court:

Panama Refining Co. vs. *Ryan,* the "hot oil" case, 293 U. S., 388;

the NRA case, *Schechter* vs. *United States,* 295 U. S., 495; and

the bituminous coal case, *Carter* vs. *Carter Coal Co.,* 298 U. S., 238.

In *Panama Refining Co.* vs. *Ryan* (*supra*), Chief Justice Hughes said:

> "The Congress left the matter" (transportation of "hot oil" exceeding state allowances) "to the President without standard or rule, to be dealt with as he pleased. The effort by ingenious and diligent construction to supply a criterion still permits such a breadth of authorized action as essentially to com-

> mit to the President the functions of a legislature rather than those of an executive or administrative officer executing a declared legislative policy."

In *Carter* vs. *Carter Coal Co.* (*supra*), Justice Sutherland said of the power to fix maximum hours of labor under the Bituminous Coal Conservation Act:

> "And a statute which attempts to confer such power undertakes an intolerable and unconstitutional interference with personal liberty and private property. The delegation is so clearly arbitrary, and so clearly a denial of rights safeguarded by the due process clause of the Fifth Amendment, that it is unnecessary to do more than refer to decisions of this court which foreclose the question" (citing cases).

In the case at bar neither the Commissioner of Internal Revenue, nor the Board of Tax Appeals has made any finding as to what the reasonable capital needs of the National Grocery Company are. No one will contend that it needs no capital. Without adequate capital it could not have discounted its bills payable—and such discounts in the year under review amounted to $493,719 (Exhibit 10, p. 141) or 57 per cent of the net earnings for the year. Assuming that the Company requires sufficient capital properly to carry on business, there has been no determination by anyone what that amount of capital is. Nor does the statute require such a finding. No standard or gauge is contained in the Act, according to which such a determination must be made by anyone. The whole matter is left to the unbridled control of the Commissioner, who, occupying the seat of Jove, may hurl the thunderbolt of a 50 per cent penalty whereso-

ever he will. The Constitution is the protector of business against such arbitrary and confiscatory acts.

It is the duty of Congress to lay down policies and establish standards, and leave to selected instrumentalities the making of subordinate rules within prescribed limits and the determination of facts to which the policy as declared by the legislature is to apply.

Schechter vs. *United States,* 295 U. S. at p. 530.

It follows that Section 104 is therefore void as to petitioner and all other *bona fide* business corporations requiring capital as their life blood.

POINT XI.

The Circuit Court of Appeals in reversing the determination of the Board followed the law, and should be affirmed.

The Circuit Court of Appeals from a study of the whole record having found that the Government offered no proof of the forbidden purpose against respondent, and that respondent affirmatively had proved it did not have the forbidden purpose, and that the earnings were accumulated for proper corporate purposes, followed the law in reversing the determination of the Board.

In 1921 the Circuit Court of Appeals below (Buffington, J.), finding that the Federal Trade Commission had disregarded a line of proof which was dispositive of the case, set aside an order of that Commission requiring the petitioner to desist from certain practices found by the Commission to be unfair competition.

Curtis Pub. Co. vs. *Federal Trade Commission,*
270 Fed. 881, 910.

On appeal this Court said:

"If there be substantial evidence relating to such facts from which different conclusions reasonably may be drawn, the matter may be and ordinarily we think should be remanded to the Commission—the primary fact finding body, with direction to make the additional findings; but if from all the circumstances, it clearly appears that in the interest of justice, the controversy should be decided without further delay, the court has full power under the statute so to do."

Federal Trade Commission vs. *Curtis Pub. Co.,*
260 U. S. 568.

"The Board of Tax Appeals is not a Court. It is an executive or administrative board, upon the decision of which the parties are given an opportunity to base a petition for review to the courts after the administrative inquiry to the board has been had and decided."

Old Colony Trust Company vs. *Commissioner,*
279 U. S. 716, at page 725.

"The function of the court is to decide whether the correct rule of law was applied to the facts found; and whether there was substantial evidence before the Board to support the finding made. * * * Unless the finding of the Board involves a mixed question of law and fact, the court may not properly substitute its own judgment for that of the Board."

Helvering vs. *Rankin,* 295 U. S. 123, 131;
General Utilities & Operating Co. vs. *Helvering,*
296 U. S. 200, 206.

In *Tex-Penn Oil Co.* vs. *Commissioner,* 83 Fed. (2d) 518, the Circuit Court of Appeals set aside a judgment of the Board of Tax Appeals for lack of substantial evidence, and this Court affirmed under the title *Helvering* vs. *Tex-Penn Oil Co.,* 300 U. S. 481. This Court said:

> "The ultimate finding is a conclusion of law or at least a determination of a mixed question of law and fact. It is to be distinguished from the findings of primary, evidentiary or circumstantial facts. It is subject to judicial review and, on such review, the court may substitute its judgment for that of the Board. Helvering *v.* Rankin, 295 U. S. 123."

See also

Jewett & Co. vs. *Commissioner,* 61 Fed. (2d) 471 (Second Circuit);

National Biscuit Company vs. *Federal Trade Commission,* 299 Fed. 733.

Because the Board disregarded the uncontradicted testimony, and drew an evil and nefarious conclusion from a state of facts which established an honest and lawful purpose, its decision was properly reversed. The reports contain many cases in which the Board has disregarded uncontradicted evidence. A few are;

Nichols v. *Comm.,* 44 Fed. (2d) 157 (C. C. A. 3rd);

Chicago Railway Equipment Co. v. *Blair,* 20 Fed. (2d) 10 (C. C. A. 7th);

Planters Operating Co. v. *Comm.,* 55 Fed. (2d) 583 (C. C. A. 8th);

Conrad & Company v. *Comm.*, 50 Fed. (2d) 576 (C. C. A. 1st);
Foster v. *Comm.*, 57 Fed. (2d) 516 (C. C. A. 5th);
Champlin v. *Comm.*, 71 Fed. (2d) 23 (C. C. A. 10th).

Conclusion.

We submit

(1) That it is not within the letter or spirit of Section 104 that it should be applied to *bona fide* business corporations which require large capital as their life blood;

(2) That the uncontradicted evidence shows that petitioner did not have a surplus in excess of the reasonable needs of its business, and did not have the prohibited purpose;

(3) That for its fiscal year ended Jan. 31, 1931 petitioner had no gains—in fact, the depreciation in all its assets was far in excess of the net earnings it reported and on which it paid income taxes.

(4) That had the management of National Grocery Company had any purpose to escape or avoid taxes a legal and proper method was at hand—they could have sold securities and properly taken losses in excess of the profits.

(5) Section 104 of the Revenue Act of 1928 as applied below to Petitioner is clearly unconstitutional,

(a) because it is not an income tax law but provides a penalty for a purpose which is beyond the power of Congress;

(b) It improperly invades the domain of functions reserved to the States by the 10th Amendment;

(c) Since there are no standards set up in the law for the determination of the "reasonable needs of business" for capital either by Directors or the Commissioner, and the penalty may be arbitrarily and capriciously applied by the Commissioner when and upon whom he will, it violates the 5th Amendment;

(d) The law reposes in the Commissioner of Internal Revenue the sole power and authority to determine by standards he alone sets up when and upon whom the penalty is applicable, the Constitution requiring that such standards be placed in the law by Congress.

It is respectfully submitted that for all the reasons aforesaid the judgment of the Circuit Court of Appeals should be affirmed.

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APPENDIX.

Containing a history of legislation attempting to compel distribution of corporate earnings commencing with the Tariff Act of 1913 and including all subsequent legislation on the same subject, testimony concerning the meaning of the law before the Committee investigating the Department of Internal Revenue in 1925, Statement by Secretary Mellon, statements of members of the Congress during debates in the Congress, and reports of congressional committees; and showing how the law has been changed and developed to the Revenue Act of 1936 which imposed a graduated tax on undistributed earnings of corporations at the suggestion of President Roosevelt.

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The Tariff Act of October 3, 1913 (H. R. 3321), Section II, 38 Statutes at Large, p. 166.

SECTION II.

A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; and a like tax shall be assessed, levied, collected, and paid annually upon the entire net income from all property owned and of every business, trade, or profession carried on in the United States by persons residing elsewhere.

Subdivision 2. In addition to the income tax provided under this section (herein referred to as the normal income tax) there shall be levied, assessed, and collected upon the net income of every individual an additional income tax (herein referred to as the additional tax) of 1 per centum per annum upon the amount by which the total net income exceeds $20,000 and does not exceed $50,000, and 2 per centum per annum upon the amount by which the total net income exceeds $50,000 and does not exceed $75,000, 3 per centum per annum upon the amount by which the total net income exceeds $75,000 and does not exceed $100,000, 4 per centum per annum upon the amount by which the total net income exceeds $100,000 and does not exceed $250,000, 5 per centum per annum upon the amount by which the total net income exceeds $250,000 and does not exceed $500,000, and 6 per centum per annum upon the amount by which the total net income exceeds $500,000. All the provisions of this section relating to individuals who are to be chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of paragraph A, shall apply to the

levy, assessment, and collection of the additional tax imposed under this section. Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his total net income from all sources, corporate or otherwise, for the preceding calendar year, under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury. For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company, or association, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company, or association shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same if distributed.

When Section II of the Tariff Act of 1913 was considered in the Senate (See Congressional Record-Senate—1913, Vol. 50, p. 4380) the following discussion occurred with respect to the provision in the income tax law taxing undistributed corporate gains and profits.

"Mr. Warren: Mr. President, may I ask the Senator a question? That alludes to profits in a corporation that are not divided?

Mr. Williams: Yes.

Mr. Warren: What would be the construction where a business is of such a nature that the risks are such that they are in the habit of going along for two or three——

Mr. Williams: This does not apply to all profits that are not divided at all. It applies only to such profits and the heaping up of such surplus as shall justify the Secretary of the Treasury in concluding that it is done for the purpose of evading the tax. Its main purpose is to prevent the formation of holding companies.

Here is a man, for example, with an income as large as Mr. Carnegie's income, let us say. There would be nothing to prevent him from organizing a holding company and passing his income from year to year up to undivided profits. I think if the Senator will watch the reading of the amendment he will understand its object."

* * * * * *

"Mr. Brandegee: It gives the Secretary of the Treasury absolute power to say exactly what surplus shall be in his opinion proper for the conduct of any business, and if the views of the managers of the business do not coincide with his views they are guilty of a fraud.

Mr. Williams: Somebody has to sit in judgment as to whether there is a fraud or not.

Mr. Brandegee: I should think that it is a very dangerous amendment."

Revenue Act of September 8, 1916 (H. R. 16763), Title I, Part I, 39 Statutes at Large, p. 758.

ADDITIONAL TAX INCLUDES UNDISTRIBUTED PROFITS.

SEC. 3. For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if

divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company or association, or insurance company is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company or association, or insurance company shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed.

Revenue Act of February 24, 1919, (Cited as Revenue Act of 1918) (H. R. 12863), Title II, 40 Statutes at Large 1072.

PROFITS OF CORPORATIONS TAXABLE TO STOCKHOLDERS.

SEC. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, such corporation shall not be subject to the tax

imposed by section 230, but the stockholders or members thereof shall be subject to taxation under this title in the same manner as provided in subdivision (e) of section 218 in the case of stockholders of a personal service corporation, except that the tax imposed by Title III shall be deducted from the net income of the corporation before the computation of the proportionate share of each stockholder or member. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

Revenue Act of November 23, 1921 (H. R. 8245), Title II, 42 Statutes at Large, p. 247.

EVASION OF SURTAXES BY INCORPORATION.

SEC. 220. That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title

and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax: *Provided,* That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

Report of the Committee on Ways and Means of the House of Representatives to accompany H. R. 8245 (Revenue Act of 1921).

SURTAX EVASION BY CORPORATE ORGANIZATION.

Section 226: Section 220 of the existing law provides that if any corporation is formed or availed of for the purpose of evading the surtax upon its stockholders through the medium of permitting its gains and profits to accumu-

late instead of being divided, the stockholders shall be taxed in the same manner as partners. By reason of the recent decision of the Supreme Court in the stock dividend case (*Eisner* v. *Macomber*, 252 U. S. 189), considerable doubt exists as to the constitutionality of the existing law. Section 226 of the bill therefore proposes to amend section 220 of the existing law so as to impose upon corporations of the character above described a flat additional income tax of 25 per cent of the net income; but if the stockholders agree, they may be taxed upon their distributive shares in the net income of the corporation in the same manner as members of a partnership, such taxes to be in lieu of all income taxes upon the corporation.

Congressional Record—House—1921
Volume 61, p. 5203.

Mr. Hawley:—"Section 226 is to prevent the formation of corporations for the purpose of preventing the imposition of the surtax upon their stockholders or members. Such corporations were formed in the endeavor to evade the law. We provide legislation by which that will be prevented in the future."

(Note: Mr. Hawley was a member of the Ways and Means Committee and was speaking in explanation of H. R. 8245. Section 226 of H. R. 8245 became Section 220 of the Revenue Act of 1921.)

Revenue Act of June 2, 1924 (H. R. 6715), Title II,
43 Statutes at Large, p. 277.

EVASION OF SURTAXES BY INCORPORATION.

SEC. 220. (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders

through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall (except as provided in subdivision (d) of this section) be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(d) As used in this section the term "net income" means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

Secretary Mellon before the Committee on Finance of the United States Senate on H. R. 6715 (Revenue Act of 1924), April 3, 1924, said of Section 220 (at page 293):

> "Secretary Mellon: You take an individual organizing a corporation and putting his holdings in it, which immediately raises the presumption that that is what it is done for.

The other class of corporation, the class like the Standard Oil Co., is different. They are organized to carry on business; they are developing the business. There is a growth to the business, and that section 220 does not apply to them. The general situation which you speak of does not exist. I do not mean to say that there are not some isolated cases, but they are few.

Senator Jones of New Mexico: The inducement there is just the same, is it not?

Secretary Mellon: No; because there is the penalty that takes away the inducement; there is a penalty of 25 per cent on any corporation that does that. You have to apply 25 per cent penalty in addition to the tax; so that no one would think of it.

Senator Jones of New Mexico: As I said awhile ago, it would be a very dull person who would organize a corporation in such a way as to come within the penalty of that section of the statute.

Secretary Mellon: Personally, I would not know how to do it myself; I do not believe it could be accomplished."

When Section 220 of the Revenue Act of 1924 was being considered in the Senate, the following discussion occurred (Congressional Record—Senate—Vol. 65, pages 7154, 7155, 7356, 7358 and 7359):

"Mr. Jones of New Mexico: The history of that section is well known to all of us who have been following revenue legislation. A provision of that sort was put into the first revenue bill in 1917 just as we were entering the war, and some Senators may recall that I predicted at that time that it would be, for all practical purposes, ineffective.

Senators will observe that the section only applies to cases where the corporation is organized for the purpose of evading surtaxes. The purpose of an individual in doing anything is always very difficult to prove.

Mr. McKellar: If the Senator will permit me to interrupt him, it is specifically provided that:

'The fact that * * * the gains or profits are permitted to accumulate beyond the reasonable needs of the business shall be *prima facie* evidence of a purpose to escape the surtax.'

That should be broad enough, I think, to cover any corporation whose gains and profits were so great that it was necessary to declare a stock dividend.

Mr. Jones of New Mexico: That provision has been in the law since 1917. The Senator from Tennessee is a lawyer and the Senator from South Carolina as well is a lawyer. I think it is understood by all lawyers that in organizing a corporation, in specifying the purposes for which the corporation is organized, the charter is made exceedingly broad; in fact, it is customary now, I think, to include in the charters of all corporations provisions which will enable them in effect to engage in any legal enterprise or industry. When can it be said that a corporation is retaining its earnings unduly or beyond the reasonable necessities of the business, when the corporation is permitted to engage in any legitimate industry? There are many corporations organized specifically for the purpose of investing and reinvesting earnings. That is a legitimate enterprise. Many people who are engaged in the investment business do it through the agency of a corporation because of the convenience of doing business, because of the limited liability attaching to the activities in the name of a corporation rather than as an individual.

Many people organize a corporation for the purpose of transferring their individual assets to it, so as to ease the matter of distribution in event of death. It is much easier to distribute to the heirs of an estate the proper share of the estate if it is a corporation, and you are merely dealing with shares of stock, than it is to divide the actual corpus of the estate, the personal property, the real estate, and have ownership in different heirs by inheritance or devise. So as a matter of convenience corporations are often organized for the purpose of an easy way of handling the estate upon death. As long as the purpose of the corporation is to be inquired into as a condition precedent to the imposition of a penalty

it will never amount to anything in my opinion." (pp. 7154-7155.)

* * * * * * *

Mr. McKellar: As I understand the purpose of section 220, it is to prevent an individual from putting his or her property in the hands of a corporation and thereby escaping the higher brackets of the income tax and simply paying a corporation tax of 12½ per cent. That is the general purpose of the provision, is it not?

Mr. Jones of New Mexico: The purpose of the provision is to prevent that; and I will say to the Senator, while I do not like to indulge in comment on purposes in enacting legislation, I think I can tell the Senator a little history which will clarify this matter in his mind.

Mr. McKellar: I should be very glad if the Senator from New Mexico would do so.

Mr. Jones of New Mexico: In 1917 I proposed to put a provision in the bill then pending to tax undistributed incomes of corporations.

Mr. McKellar: Yes; I remember it very well.

Mr. Jones of New Mexico: In the bill as first reported to the Senate the Finance Committee adopted that provision; but in the meantime, because of additional calls upon Congress for funds by the War Department, the bill went back to the committee, and persons in control of the corporations who did not want that thing done commenced pouring in their protests against it. So the majority of the Finance Committee opposed such a tax and put this provision in so that they could say that there was a provision in the bill to prevent the evasion of surtaxes. As I predicted then, however, and still predict, it will have no such effect.

Mr. McKellar: The letter of the Secretary of the Treasury, which was written, as I recall, in January or February last, specifically states that there has been no attempt to enforce the provision, but the Secretary stated at that time—if the Senator from South Carolina will permit me to interrupt him further——

Mr. Dial: Certainly.

Mr. McKellar: The Secretary of the Treasury stated at that time that an amendment would be offered to this section which would so improve it as to cause section 220 to have the desired effect. What I wish to know from the Senator is whether any such proposal was made. Apparently section 220 is as nugatory in the pending bill as it was in the last one.

Mr. Jones of New Mexico: Mr. President, I may say that I undertook to test the real sentiment of the majority of the committee upon that question, and moved to strike out the words "for the purpose of" on page 69, line 5, so that where corporations were formed or availed of so as to evade the surtaxes a remedy might be provided, but every member of the majority side of the committee, as I expected, opposed the motion which I had made, showing that there is no expectation through this section of preventing corporations being availed of whether for one purpose or another so as to evade the high surtaxes." (p. 7155.)

"Mr. Simmons: The Secretary ought to have attacked it from the standpoint that the creation of this new species of corporations was for the purpose of evading taxes and that such corporations were void and ineffective as accomplishing that purpose, and he should have sought to impose upon them the same tax upon that income that would have been imposed upon it in the hands of the original corporation. That is the angle from which he ought to have attacked it.

Mr. Norris: Yes.

Mr. Simmons: Now, all sorts of devices are resorted to frequently to escape burdens or to escape indebtedness. We have an instance of that in the case of some debtors. Sometimes debtors seek by fraudulent transfers of their property and other fraudulent devices to escape their indebtedness; but the courts will look behind such transactions and will ascertain what was the motive of the transaction, and if it would accomplish a fraud, it is a void transaction as to the debtor. So if these corporations are flagrantly and deliberately created for the sole purpose—and that seems to be the Secretary's idea, and

that seems to be the fact—for the sole purpose of evading taxes due the Government, then they are fraudulent concerns.

Mr. Norris: I should think so.

Mr. Simmons: The courts would look behind them, and if they found that they were in fraud of the Government they would hold them to be ineffective, and that their income should be charged against them just as it should be charged against the original corporation." (P. 7356.)

* * * * * * *

"Mr. Jones: * * * In the consideration of the bill passed in 1917, this question was discussed at length, and under the laws of practically all of the States in the Union you may organize a corporation for almost any lawful purpose. In my State the law specifically provides that you may organize a corporation for any lawful purpose, and we all know that the charters of most corporations are just as broad as the imagination can make them. It costs no more to have your charter broad, so that you may engage in any kind of lawful business. The investment business is a lawful business. The holding of properties and assets is a lawful business, and under this provision you can not prevent the organization of these corporations, which will as a matter of fact be availed of, so that the result will be to take away the possibility of collecting surtaxes on these large incomes. That is just as inevitable as that the sun will rise tomorrow. You can not say that a man is organizing a corporation for the purpose of evading taxation, when he has a legal right to do the thing which he is attempting to do." (P. 7358.)

* * * * * * *

"Mr. King: I would like to ask the Senator from Nebraska what proof would be required to determine what are "the reasonable needs of business?" The able Senator from Utah (Mr. Smoot), the chairman of the committee, has contended very forcefully, that each corporation ought to have a large reserve, a large surplus. Many wise business men insist upon an enormous surplus. Others insist upon a reduced

surplus, and there is very wide ground there for a divergence of opinion as to what would be a reasonable surplus. There are no guides prescribed in the statute to determine, and there is the discretion which is allowed the executive officers.

Mr. Norris: That is true. That may be a place where an amendment should be made, if anybody can suggest an amendment which would take away or decrease that broad discretion allowed. Of course, if a corporation were organized purely as an investment company, and for nothing else, that discretion would not exist; but the second part of the proposition, as to the amount which it would be reasonable to keep on hand, is a very broad proposition. If there is any way to amend the bill and make it more concrete, it seems to me we ought to do it. I want to see this remedied." (P. 7359.)

In 1925 a Select Committee on Investigation of the Bureau of Internal Revenue, 68th Congress, held hearings and took testimony. There was present on behalf of the Bureau of Internal Revenue, Mr. C. R. Nash, Assistant to the Commissioner, and Mr. A. W. Gregg, Solicitor of the Bureau.

Mr. Gregg and Mr. Manson testified before the Committee on May 27, 1925, concerning Section 220 of the Acts of 1921 and 1924 (being substantially the same as Section 104 of the Act of 1928) as follows:

"Mr. Gregg: Take the cases to which it was intended to apply. The taxpayer, his wife and children, transfer all of their stock to a corporation. The corporation, which they have organized just for that purpose, receives the dividends on this stock, and distributes none of the dividends. Thus the members of the family, the taxpayer and his wife and children, avoid the payment of a surtax.

The Chairman: Was that the only case it was intended to get at?

Mr. Gregg: No; it is not the only case, but it is the case that it was primarily aimed at." (Page 3835.)

"Mr. Manson: When I first became connected with this committee it was in the capacity of statistician, and in preparing the questionnaire for information I had section 220 of the acts of 1921 and 1924 under consideration. The questionnaire was prepared with the view to bringing out such information as would throw light upon both the administration of section 220 and the economic questions involved in section 220. * * *

This section probably delegates to the commissioner more authority, more discretion, which would be of vital consequence to the taxpayers of the country generally than any other section of the income tax law. Among other things, it delegates to the commissioner the right to determine whether or not accumulations of earnings are reasonably necessary for the conduct of the corporate business. That, in effect, gives to the commissioner, if he chooses to exercise that authority to the full extent delegated by Congress, a right to review the financial managements and to act as a sort of an appellate court over the board of directors in determining the financial policy of every corporation in the United States. * * *

Senator Watson: Does anybody but an expert know what section 220 means?

Mr. Manson: Well, I am going to state some of the problems that arise out of it. I am not prepared to say now what, in my judgment, it means. * * *

Senator Watson: I am not so much interested in that as I am in knowing how, if at all, section 220 can be simplified. The Committee on Finance had that question up, as Mr. Gregg will remember. We went over it, and after we had wrestled with it time and again, on many occasions, we all came to the conclusion that we did not know what it meant, and let it go in.

Mr. Manson: Well, I do not blame you.

Senator Watson: Of course, Mr. Gregg understood it.

Mr. Gregg: I never claimed to.

Senator Watson: Well, but we thought you did. At least, you gave the only explanation of it that anybody ever did. Doctor Adams went over it, and,

of course, we had great respect for his knowledge and ability. I talked with him privately about it and we were trying to see if there was not some way in which it could be simplified, so that the wayfaring man, though a fool, need not err therein, but found that it could not be done. The problems with which it dealt were, in their nature, so abstruse and complex that the language dealing with those problems, of necessity, could not be expressed plainly and simply, as was the case with the other tax sections.

I might say in connection with my statement that the members of the Finance Committee did not know what it meant or were not able to come to a conclusion about it—was too drastic and sweeping. We all had our ideas about what it meant, of course'' (pp. 3844 and 3845 of the Investigation).

(Beginning at the bottom of p. 3848):

''Mr. Manson: This section makes a holding company or an investment company which accumulates its profits, *prima facie* evidence; that is, in the case of a holding company or investment company, the fact that it is a holding company or an investment company is *prima facie* evidence of an attempt to defeat the surtax, provided the company accumulates its profits.

Right there you have a problem. There are some cases which will come clearly within section 220. There are some cases that come clearly outside of it. The vast number come between those two.

Let me illustrate: A large New York bond house is incorporated. It accumulates very large business profits of earnings. The business of this corporation is the underwriting of bond issues and the sale of those bond issues to the public.

It can not be said that that corporation is a mere holding company, because it is engaged in the very active business of buying and selling bonds. It can not be said, no matter to what extent it accumulates its earnings, that those earnings are not required for the corporate business, because there is no year in which that corporation, notwithstanding the amount that it accumulates, is not required to go to the banks

and borrow money for the purpose of financing the underwriting of bonds.

As long as a corporation is doing a business which requires it to borrow money from the banks it is certainly impossible for the department to say that it does not need its own money.

There is a case that comes clearly outside of the operation of this section. That corporation has at times idle capital. That capital has not been permitted to remain in cash. They carry the bonds and stocks to keep that capital working while it is not required for the regular business of the corporation.

We have at the other end of the line, as it were, the case of an individual who owns several million dollars of stock. There is no change in his holdings. He organizes a corporation to hold his stock. The only purpose of that corporation is to collect the dividends and accumulate them.

There is a clear case that comes under the application of this section.

The regulation adopted in construing this section confined the application of the section to the latter class of cases.

Section 220 of the statutes is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon the stockholders, through the device of permitting its gains and profits to accumulate instead of being distributed."

(At page 3852):

"Senator Jones of New Mexico: Yes; and I stated at the time that the section would never have any practical effect, and I do not believe it has had. The thing to do is to try to equalize or to do away with the disparity in taxation as between individuals and corporations. That is the only remedy that I know of for the problem.

Mr. Manson: In my judgment, such judgment as I have, the section is founded upon an economic fallacy, and attempts to treat the symptom of a weakness in the system of taxation. I am not prepared to say that this section is not a good policeman, to use an expression that I heard the chairman use this

morning; in other words, that the fear of the application of it may not be a deterrent; but I can see where the section itself is so weak that anyone who is at all clever can get around it, without the least bit of trouble."

(At page 3857):

"Senator Jones of New Mexico: I was just wondering whether any special attention has been given to the constitutionality of the statute against a corporation being availed of.

Take that particular case. There is a corporation which existed and was doing business. It is winding up its affairs. The result is that the taxpayer does not pay much tax, but what right has the Government, in the exercise of the power to tax income, to force a corporation to distribute its earnings? I do not see how you can question that transaction, or reach it, rather, other than through a tax upon the corporation itself.

Mr. Gregg: Of course, section 220 applies to the corporation itself, Senator.

Senator Jones of New Mexico: But how can you, in the absence of some provision for taxing a corporation, say that that is a fraud upon the Government?

Mr. Gregg: We do not have to say it is fraud, if it is——

Senator Jones of New Mexico: I know; but the intent to avoid taxation is what you reach, and how can you say that that is such an attempt? For aught we know or can tell, they keep the assets of the corporation; they may want to invest them some other way in the name of the corporation.

Mr. Gregg: Under the statute we do not even have to go to intent.

Senator Jones of New Mexico: I wonder, from a constitutional standpoint, how you can apply it to a thing of this sort.

Mr. Gregg: The constitutionality has been questioned. It seems to me that we can go rather far in prohibiting, by attacks on the corporation itself, a tax on the income of the corporation, this attempt to

evade taxes. We can go pretty far in preventing such action.

Senator Watson: You mean a penalty?

Mr. Gregg: Yes, sir; it is called a tax. It does not say it is a penalty. It is a penalty, however.

Senator Watson: It is a penalty?

Mr. Gregg: Yes.

Senator Jones of New Mexico: Under existing law the only object or any other result that could have been brought about other than that which happened in through requiring that this corporation declare dividends. I do not think you can require a corporation, for taxation purposes, to do anything.

Mr. Gregg: You can not do that.

Senator Jones of New Mexico: You have to meet the situation that the law itself covers and impose a tax. I do not see anything in the present law which would impose a tax under the circumstances here, if it were organized with the intent of doing this thing and using it, and so on, that is one thing."

(At page 3859):

"Senator Jones of New Mexico: That company was doing a legitimate business. It received these stocks and bonds in payment for its property, and of course collected the dividends and coupons on its stocks and bonds. Now, to say, that that is availed of would be to force a corporation to a distribution of its dividends.

I quite agree that we can reach the matter, but not through the provisions of section 220. We can reach it by imposing upon the dividends received by that corporation a tax on what is undistributed, and it there becomes a tax upon income. * * *

Senator Jones of New Mexico: I do not see how you can compel a distribution of assets under an authority to tax income.

Mr. Manson: I do not, either; but suppose you attempted to impose a penalty here, because they did not under the income tax law? They might be able to come in and show that they were not holding this property to escape tax, because they expected the market on General Motors stock to go up, and that

the market conditions were unfavorable, and that they wanted to hold that stock until the market on General Motors improved. That would be a perfectly legitimate reason.

Senator Jones of New Mexico: And they might want to use this corporate entity here for the purpose of engaging in some other line of business."

(At page 3866):

"Senator Jones of New Mexico: If the charter is broad enough to include the different businesses, how can the Commissioner of Internal Revenue restrict it to one line of industry?

Mr. Manson: Under such circumstances, of course, as applied to manufacturing companies and things of that sort, there is no force or effect to the statute whatever.

If the statute is to be construed as permitting the commissioner discretion, I point out an illustration of that kind to show the vast amount of discretion, and to show that questions are raised that are far more troublesome than any that we have ever presented to this committee in all the work that we have done from the time that we began to hold hearings."

Revenue Act of February 26, 1926 (H. R. 1), Title II, 44 Statutes at Large, part II, p. 34.

EVASION OF SURTAXES BY INCORPORATION.

SEC. 220. (a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall (except as provided in subdivision (d) of this section) be

computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

(c) When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

(d) As used in this section the term "net income" means the net income as defined in section 232, increased by the sum of the amount of the deduction allowed under paragraph (6) of subdivision (a) of section 234, and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(e) The tax imposed by subdivision (a) of this section shall not apply in respect of any taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

In the **report of the Joint Committee on Internal Revenue taxation to the Committee on Ways and Means of the House of Representatives, and the Committee on Finance of the Senate, dated November 15, 1927,** it is stated, regarding Section 220:

> "A careful investigation of this subject and of individual cases which appear to come within the scope of the provision has been made, resulting in the conclusion that the present statute is obscure and difficult of administration. The provision has been effective only in so far as it has deterred the formation of personal holding companies or has stimulated distributions.
>
> The two greatest difficulties facing the administration in applying the present provision consist, first, in proving the 'purpose' to evade, and, second, in proving what constitutes 'the reasonable needs of the business.' The evidence necessary to prove the first point is almost always unobtainable, and the definition of the reasonable needs of a business, required in the second case, is generally beyond the power of the bureau, at least, in the case of operating companies.
>
> The incentive to incorporate in order to avoid surtaxes has largely disappeared."

The report contained the following recommendation:

> "7. A change in the act is recommended which will automatically encourage reasonable distribution of dividends without causing unwise distributions and which will make the retention of section 220 unnecessary."

Under the discussion of the recommendation was the following:

> "It is extremely difficult for the Bureau of Internal Revenue effectively to enforce the provisions of section 220.
>
> The principal difficulty arises from the fact that section 220 is necessarily vague in its terms. The test of its application (except in cases of mere holding and investment companies) is whether the ac-

cumulations of income are beyond the reasonable needs of the business. The intent of the statute on this point is clear, but the difficulty of determining the facts in most cases is extremely great. The needs of a business depend largely on the intention of its owners in regard to its development. In deciding such cases long after the event, the commissioner is called upon to substitute his business judgment as to the prospective needs of an enterprise at a given date for the current judgment of those responsible for the conduct of the business. In some industries, such as banking, the reasonable needs of the business appear to be limited only by the imagination of the directors. A more specific definition of the test to be applied which will work out satisfactorily in all cases seems well-nigh impossible. Arbitrary rules setting up certain required percentages of distribution in relation to total income or total surplus are obviously unsatisfactory, because of the fact that no two corporations are similarly situated. The problem is very much more difficult than determination of reasonable salaries, reasonable allowances for depreciation, and similar problems.

The second difficulty is the requirement that the Bureau of Internal Revenue find in all cases (except in those involving mere holding and investment companies) the existence of 'a purpose to' evade surtax on the part of the taxpayer. This not only involves the determination of motive or purposes which is particularly difficult in the case of a corporation since corporate action is determined by the board of directors or the principal stockholders or some of them, but involves a consideration of the various purposes which may have influenced the judgment of the various individuals who determined the action of the corporation."

The Committee ended its report as follows:

"The joint committee approves in principle the recommendations in Volume I except those relating to section 220, and the provisions relating to the expense of transfers in the field service, which it neither approves nor disapproves."

Revenue Act of May 29, 1928 (H. R. 1), Title I, 45 Statutes at Large, p. 814.

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23(p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits

for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

When Section 104 of the Revenue Act of 1928 was being considered in the House, Mr. Garner (now Vice President of the United States) who was a member of the Committee on Ways and Means made the following statement (Congressional Record—House—1927, Volume 69, page 519):

> "I am sure you will remember what section 220 in the present law is. It was intended to enable the Secretary of the Treasury to force corporations to distribute their profits and subject their shareholders to the tax levied by Congress. It has been in the statute for some years."

Representative Green of Iowa said, page 521:

> "You will not find much direct revenue raised by this provision but the effect will be to dissolve a number of these corporations that were formed to escape the surtax, and the persons who own them will pay their surtax in the regular way, the same as other people. That will be the effect. * * *
>
> I am told by gentlemen familiar with the operations of these corporations and gentlemen connected with large accounting firms and others that section 220 of the present law, while it never brought in any revenue, operated in such a way as to cause a great many of these corporations to dissolve. It has been, in fact, a most excellent scarecrow if it has been nothing else, and it has driven these people into taking such action as to avoid the penalties prescribed."

During the discussion of section 104 of the Revenue Act of 1928 in the Senate in 1928, Senator Smoot made the following statement (Congressional Record—Senate—1928 Volume 69, page 7976):

"I am not certain that the limitations found in section 105, pages 68 and 69, of the pending bill are a sufficient curb or guide to the Secretary of the Treasury in exercising the great discretion allowed him in dealing with this question of reserves.

The Secretary alone is to determine, if I interpret the section correctly, what would be a proper reserve or accumulation, before the penalty of 50 per cent is applied. One Secretary of the Treasury or one Federal official connected with the revenue branch of the Government might regard a certain amount of reserve or surplus as proper. A different rule might be prescribed by his successor."

Senator King said (pp. 7976 and 7977):

"How much shall be allowed as a surplus before the penalty shall be applied? I do not know. Should we attempt to circumscribe those engaged in business and limit the amount of reserves and accumulations before the penalty of 50 per cent is applied, or should the entire matter be committed to the discretion of those administering the law?

I am not satisfied with this section, and yet I am not in position to offer an amendment to supersede it. The Finance Committee considered the House amendment, which was intended to clarify the situation; and I think that after due consideration the committee reached the conclusion that instead of clarification it would add to the uncertainty and dubiety if attempts were made to prescribe the limitation upon the amount allowed as reserves and the circumstances under which such reserves should be set up.

MR. SIMMONS: Mr. President, I think Senators on this side agree with the general propositions laid down by the Senator from Utah. We have criticised this provision in the present law ever since it was enacted. We have recognized the fact that it lodged almost unlimited discretion in the Secretary of the Treasury; and we have complained bitterly that for many years after its original enactment the Secretary of the Treasury did not exercise that discretion at all, but permitted these surpluses to be accumulated in gigantic sums, without taking any action to force their distribution.

In all of our discussions about this question, however, we have all realized the fact that sound economy in the conduct of a business by a corporation made it necessary that they should set aside a certain part of their annual earnings for purposes of enlargement, for purposes of improvement of their methods and their equipment, and that the requirements of one class of corporations in this respect were different from those of another class of corporations; that it was almost impossible to lay down any fixed rule to regulate the distribution of these accumulated surpluses which would not be to the disadvantage of some and to the advantage of other corporations. In that state of inability to adjust what the several corporations of the country might legitimately and reasonably require in order to be upon a safe footing in the conduct of their business, and to enlarge and develop their business and improve their methods, we felt that we were hopeless unless the Secretary of the Treasury would enforce this provision of the law.

I know that both sides of the Finance Committee have sought to devise some method that might place safeguards around an unwise exercise of discretion on the part of the Secretary of the Treasury, or might coerce him to enforce the law; but I confess that neither side of the committee up to this time has been able to suggest any satisfactory solution of that problem. To my mind, the House provision is not a satisfactory solution of it; and the exigencies created in the present condition of things with respect to this matter are nothing like so urgent, nothing like so great and important, as they were when taxes were higher than they are now."

Regulations 74, Relating to Taxes Under 1928 Law (pp. 155 to 157 inc.).

Art. 541. TAXATION OF CORPORATION UTILIZED FOR EVASION OF SURTAX.—Section 104 is designed to discourage the formation or use of a corporation for the purpose of preventing the imposition of surtaxes upon its shareholders,

through the device of permitting its gains and profits to accumulate instead of being distributed. If a domestic or foreign corporation is so formed or availed of, it is subject to a tax at the rate of 50 per cent upon its net income in addition to the tax imposed by section 13. However, the additional tax at the rate of 50 per cent does not apply for 1928 or any subsequent taxable year if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive share, whether distributed or not, of the net income of the corporation for such year or years. Any amount so included in the gross income of a shareholder shall be treated as a dividend received, and any subsequent distribution made by the corporation out of the earnings or profits for such taxable years shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Art. 542. PURPOSE TO ESCAPE SURTAX.—Prima facie evidence of a purpose to escape the surtax exists where a corporation is a mere investment company, where a corporation has practically no business except holding stocks, securities, or other property and collecting the income therefrom or investing therein, or where a corporation other than a mere holding or investment company permits its gains and profits to accumulate beyond the reasonable needs of the business. The statutory presumption that a mere holding or investment company is subject to the additional tax imposed by section 104 may be overcome if the corporation can show, either by reason of the fact that it distributed a large portion of its earnings for the year in question, or that its stock was held not by the members of a family or of a small group but by a large number of persons and in comparatively small blocks, or by other evidence, that it was not availed of for the purpose of preventing the imposition of the surtax upon its shareholders.

The business of a corporation is not merely that which it has previously carried on, but includes in general any line

of business which it may legitimately undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to escape the surtax. When one corporation owns the stock of another corporation in the same or a related line of business and in effect operates the other corporation, the business of the latter may be considered in substance the business of the first corporation. Gains and profits of the first corporation put into the second through the purchase of stock or otherwise may therefore, if a subsidiary relationship is established, constitute employment of the income in its own business. To establish that the business of one corporation can be regarded as including the business of another it is ordinarily essential that the first corporation own substantially all of the stock of the second. Investment by a corporation of its income in stock and securities of another corporation is not without anything further to be regarded as employment of the income in its business.

Art. 543. UNREASONABLE ACCUMULATION OF PROFITS.—An accumulation of gains and profits is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent reasonable accumulations of surplus for the needs of the business. No attempt can be made to enumerate all the ways in which gains and profits of a corporation may be accumulated for the reasonable needs of the business. Distributions made by a corporation shortly after the close of its taxable year shall be taken into consideration in determining the reasonableness of the amount of earnings and profits of the corporation retained by it for such year. Undistributed income is properly accumulated if invested in increased inventories or additions to plant reasonably needed by the business. It is properly accumulated if retained for working capital required by the business or in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring

bonds issued by the corporation. In the case of a banking institution the business of which is to receive and loan money, using capital, surplus, and deposits for that purpose, undistributed income actually represented by loans or reasonably retained for future loans is not accumulated beyond the reasonable needs of the business. The nature of the investment of gains and profits is immaterial if they are not in fact needed in the business. It is an unreasonable accumulation of gains and profits by corporations with the purpose of enabling their shareholders to escape surtaxes on such gains and profits which subjects such corporations to the additional tax imposed by section 104. Among other things, the financial condition of the corporation at the close of the taxable year and the manner in which its funds are invested at that date, determine the reasonableness of the accumulations.

For the purpose of section 104 the term "net income" means the net income of the corporation as defined in section 21 increased by the sum of (1) the amount received as dividends and allowed as a deduction by section 23 (p), plus (2) the amount of interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner. The Commissioner, or any collector upon direction from the Commissioner, may require any corporation to furnish a statement of its accumulated gains and profits, the name and address of, and number of shares held by, each of its shareholders, and the amounts that would be payable to each, if the income of the corporation were distributed. (See section 149 (c).)

Revenue Act of June 6, 1932 (H. R. 10236), Title I, 47 Statutes at Large, p. 195.

SEC. 104. ACCUMULATION OF SURPLUS TO EVADE SURTAXES.

(a) If any corporation, however created or organized, is formed or availed of for the purposes of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by section 13 and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax.

(b) The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to escape the surtax.

(c) As used in this section the term "net income" means the net income as defined in section 21, increased by the sum of the amount of the dividend deduction allowed under section 23(p) and the amount of the interest on obligations of the United States issued after September 1, 1917, which would be subject to tax in whole or in part in the hands of an individual owner.

(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribu-

tion made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included.

Revenue Act of May 10, 1934 (H. R. 7835), Title I, 48 Statutes at Large, pp. 702 and 751.

SEC. 102. SURTAX ON CORPORATION IMPROPERLY ACCUMULATING SURPLUS.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the adjusted net income of every corporation (other than a personal holding company as defined in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting gains and profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

(1) 25 per centum of the amount of the adjusted net income not in excess of $100,000, plus

(2) 35 per centum of the amount of the adjusted net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax.

(c) DEFINITION OF "ADJUSTED NET INCOME".—As used in this section, the term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but diminished by the amount of dividends paid during the taxable year.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year, upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) 30 per centum of the amount thereof not in excess of $100,000; plus

(2) 40 per centum of the amount thereof in excess of $100,000.

(b) DEFINITIONS.—As used in this title—

(1) The term "personal holding company" means any corporation (other than a corporation exempt from taxation under section 101, and other than a bank or trust company incorporated under the laws of the United States or of any State or Territory, a substantial part of whose business is the receipt of deposits, and other than a life-insurance company or surety company) if—(A) at least

80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For the purpose of determining the ownership of stock in a personal holding company—(C) stock owned, directly or indirectly, by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries; (D) an individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per centum in value of the outstanding stock; and (E) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(2) The term "undistributed adjusted net income" means the adjusted net income minus the sum of:

(A) 20 per centum of the excess of the adjusted net income over the amount of dividends received from personal holding companies which are allowable as a deduction for the purposes of the tax imposed by section 13 or 204;

(B) Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; and

(C) Dividends paid during the taxable year.

(3) The term "adjusted net income" means the net income computed without the allowance of the dividend deduction otherwise allowable, but minus the sum of:

(A) Federal income, war-profits, and excess-profits taxes paid or accrued, but not including the tax imposed by this section;

(B) Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23(o) for the purposes therein specified; and

(C) Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117(d).

(4) The terms used in this section shall have the same meaning as when used in Title I.

(c) ADMINISTRATIVE PROVISIONS.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Title I of this Act, shall insofar as not inconsistent with this section, be applicable in respect of the tax imposed by this section, except that the provisions of section 131 of that title shall not be applicable.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the "adjusted net income" of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) IMPROPER ACCUMULATION OF SURPLUS.—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

Revenue Act of August 30, 1935 (H. R. 8974), Title I, 49 Statutes at Large, p. 1674.

SEC. 109. PERSONAL HOLDING COMPANIES.

(a) Section 351(a) of the Revenue Act of 1934 is amended to read as follows:

> "(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year, upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:
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> "(1) 20 per centum of the amount thereof not in excess of $2,000; plus
>
> "(2) 30 per centum of the amount thereof in excess of $2,000 and not in excess of $100,000; plus
>
> "(3) 40 per centum of the amount thereof in excess of $100,000 and not in excess of $500,000; plus
>
> "(4) 50 per centum of the amount thereof in excess of $500,000 and not in excess of $1,000,000; plus
>
> "(5) 60 per centum of the amount thereof in excess of $1,000,000."

(b) Section 351(b)(2)(C) of such Act is amended by striking out the period at the end thereof and inserting in lieu thereof a comma and the following: "and distributions (not in complete or partial liquidation and not a 'dividend' as defined in section 115) made during the taxable year out of earnings or profits of such year."

(c) The amendments made by this section shall apply only in the case of taxable years beginning after December 31, 1935.

On March 3, 1936, President Roosevelt in a letter to the Congress said:

> "The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether.
>
> This method of evading existing surtaxes constitutes a problem as old as the income-tax law itself. Repeated attempts by the Congress to prevent this form of evasion has not been successful. The evil has been a growing one. It has now reached disturbing proportions from the standpoint of the inequality it represents and of its serious effect on the Federal revenue. Thus the Treasury estimates that, during the calendar year 1936, over 4½ billion dollars of corporate income will be withheld from stockholders. If this undistributed income were distributed, it would be added to the income of stockholders and there taxed as is other personal income. But, as matters now stand, it will be withheld from stockholders by those in control of these corporations. In one year alone, the Government will be deprived of revenues amounting to over $1,300,000,000.
>
> A proper tax on corporate income (including dividends from other corporations), which is not distributed as earned, would correct the serious twofold inequality in our taxes on business profits if accompanied by a repeal of the present corporate income tax, the capital-stock tax, the related excess-profit tax, and the present exemption of dividends from the normal tax on individual incomes. The rate on undis-

tributed corporate income should be graduated and so fixed as to yield approximately the same revenue as would be yielded if corporate profits were distributed and taxed in the hands of stockholders.

Such a revision of our corporate taxes would effect great simplification in tax procedure, in corporate accounting, and in the understanding of the whole subject by the citizens of the Nation. It would constitute distinct progress in tax reform'' (see Report of the Committee on Ways and Means to the House of Representatives to accompany H. R. 12395 Revenue Act of 1936).

Revenue Act of June 22, 1936 (H. R. 12395), Title I, 49 Statutes at Large, pp. 1655, 1676 and 1732.

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) DEFINITIONS.—As used in this title—

(1) The term ''adjusted net income'' means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

(C) In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26(d).

(D) In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) The term ''undistributed net income'' means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

(c) ADJUSTED NET INCOME LESS THAN $50,000.—

(1) SPECIFIC CREDIT.—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) APPLICATION OF SPECIFIC CREDIT.—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount specific credit.

(d) EXEMPTION FROM SURTAX.—The following corporations shall not be subject to the surtax imposed by this section:

(1) Banks as defined in section 104.

(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.

(3) Insurance companies subject to the tax imposed under section 201, 204, or 207.

(4) Foreign corporations.

(5) Corporations which, by reason of deriving a large portion of their gross income from sources within a possession of the United States, are entitled to the benefits of section 251.

(6) Corporations organized under the China Trade Act, 1922.

(7) Joint Stock Land Banks organized under the Federal Farm Loan Act, as amended.

(e) EXEMPT CORPORATIONS.—For corporations exempt from taxation under this title, see section 101.

(f) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

(g) IMPROPER ACCUMULATION OF SURPLUS.—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this title) upon the net income of every corporation (other than a personal holding company as defined

in section 351) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed—

(1) In the case of corporations not subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

25 per centum of the amount of the retained net income not in excess of $100,000, plus

35 per centum of the amount of the retained net income in excess of $100,000.

(2) In the case of corporations subject to the surtax on undistributed profits imposed by section 14, a surtax equal to the sum of the following:

15 per centum of the amount of the retained net income not in excess of $100,000, plus

25 per centum of the amount of the retained net income in excess of $100,000.

(b) PRIMA FACIE EVIDENCE.—The fact that any corporation is a mere holding or investment company, or that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business, shall be *prima facie* evidence of a purpose to avoid surtax upon shareholders.

(c) DEFINITIONS.—As used in this title—

(1) SPECIAL ADJUSTED NET INCOME.—The term "special adjusted net income" means the net income minus the sum of—

(A) TAXES.—Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year, to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law.

(B) DISALLOWED CHARITABLE, ETC., CONTRIBUTIONS.—Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees described in section 23 (o), for the purposes therein specified.

(C) DISALLOWED LOSSES.—Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(D) BANK AFFILIATES.—In the case of a holding company affiliate (as defined in section 2 of the Banking Act of 1933), the amount allowed as a credit under section 26 (d).

(E) NATIONAL MORTGAGE ASSOCIATIONS.—In the case of a national mortgage association created under Title III of the National Housing Act, the amount allowed as a credit under section 26 (e).

(2) RETAINED NET INCOME.—The term "retained net income" means the special adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends. For the purposes of this subsection, such credits shall be computed by substituting in section 26 (c) and in section 27 for the words "adjusted net income" wherever appearing in such sections the words "special adjusted net income".

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if (1) all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the retained net income of the corporation for such year, and (2) 90 per centum or more of such retained net income is so included in the gross income of shareholders other than corporations. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed

stock in a personal holding company—(C) stock owned, directly or indirectly, by a corporation, partnership, estate, or trust shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries; (D) an individual shall be considered as owning, to the exclusion of any other individual, the stock owned, directly or indirectly, by his family, and this rule shall be applied in such manner as to produce the smallest possible number of individuals owning, directly or indirectly, more than 50 per centum in value of the outstanding stock; and (E) the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

(2) The term "undistributed adjusted net income" means the adjusted net income minus the sum of:

(A) 20 per centum of the excess of the adjusted net income over the amount of dividends received from personal holding companies which are allowable as a credit for the purposes of the tax imposed by section 13 or 204;

(B) Amounts used or set aside to retire indebtedness incurred prior to January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness; and

(C) The amount of the dividends paid credit provided in section 27, computed without the benefit of subsection (b) thereof (relating to the dividend carry-over).

(3) The term "adjusted net income" means the net income minus the sum of:

(A) Federal income, war-profits, and excess-profits taxes paid or accrued during the taxable year to the extent not allowed as a deduction by section 23, but not including the tax imposed by this section or a corresponding section of a prior income-tax law;

(B) Contributions or gifts, not otherwise allowed as a deduction, to or for the use of donees

to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) TAX ON PERSONAL HOLDING COMPANIES.—For surtax on personal holding companies, see section 351.

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES.

(a) IMPOSITION OF TAX.—There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income of every personal holding company a surtax equal to the sum of the following:

(1) 8 per centum of the amount thereof not in excess of $2,000; plus

(2) 18 per centum of the amount thereof in excess of $2,000 and not in excess of $100,000; plus

(3) 28 per centum of the amount thereof in excess of $100,000 and not in excess of $500,000; plus

(4) 38 per centum of the amount thereof in excess of $500,000 and not in excess of $1,000,000; plus

(5) 48 per centum of the amount thereof in excess of $1,000,000.

(b) DEFINITIONS.—As used in this title—

(1) The term "personal holding company" means any corporation (other than a corporation exempt from taxation under section 101, and other than a bank, as defined in section 104, and other than a life-insurance company or surety company) if—(A) at least 80 per centum of its gross income for the taxable year is derived from royalties, dividends, interest, annuities, and (except in the case of regular dealers in stock or securities) gains from the sale of stock or securities, and (B) at any time during the last half of the taxable year more than 50 per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. For the purpose of determining the ownership of

described in section 23 (o) for the purposes therein specified, including, in the case of a corporation organized prior to January 1, 1936, to take over the assets and liabilities of the estate of a decedent, amounts paid in liquidation of any liability of the corporation based on the liability of the decedent to make any such contribution or gift, to the extent such liability of the decedent existed prior to January 1, 1934; and

(C) Losses from sales or exchanges of capital assets which are disallowed as a deduction by section 117 (d).

(4) The terms used in this section shall have the same meaning as when used in Title I.

(c) ADMINISTRATIVE PROVISIONS.—All provisions of law (including penalties) applicable in respect of the taxes imposed by Title I of this Act, shall insofar as not inconsistent with this section, be applicable in respect of the tax imposed by this section, except that the provisions of section 131 of that title shall not be applicable.

(d) PAYMENT OF SURTAX ON PRO RATA SHARES.—The tax imposed by this section shall not apply if (1) all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the adjusted net income of the corporation for such year, and (2) 90 per centum or more of such adjusted net income is so included in the gross income of shareholders other than corporations. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his pro rata share, be exempt from tax in the amount of the share so included.

(e) IMPROPER ACCUMULATION OF SURPLUS.—For surtax on corporations which accumulate surplus to avoid surtax on stockholders, see section 102.

Speaking on the 1936 law in the Senate, Senator George (Congressional Record—Senate—1936—Volume 80, page 8804) said:

> "I now come to a point which the Treasury officials have not properly evaluated. It is a point to which they either overlooked or did not properly weigh, as it seems to me. The English corporations have withheld a greater percentage of their earnings than the American corporations. How is that accounted for? It is accounted for by one fact, which ought not to be lost sight of, and that is that corporate dividends or earnings are not necessarily withheld for the purpose of tax avoidance, but they are withheld because, as a matter of judgment and of sound business, it is of actual profit in the administration of the corporations to do so. Let the Senate bear that fact in mind. Under the nearest comparable system to ours there is no inducement to tax avoidance, because the tax must be paid if distributed to the individuals, and must be paid also by the corporation if withheld.
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>
> Mr. President, there is one other feature of the subject that I wish to discuss, because I desire to be fair. Because there is opportunity for tax avoidance by those taxpayers who, if the earnings of corporations were distributed, would be called upon to pay a much higher tax then they would pay when the earnings are permitted to be plowed back or to remain in the corporation, and because the Treasury has suffered by reason of the acts of some who have abused our present law, is no sufficient reason why we should look with a narrow and contracted vision at those particular offenders and make laws that apply to the corporation that is actually withholding its income for legitimate purposes, for the purpose of

carrying forward its program, for the purpose of employing men, for the purpose, Mr. President, of making it possible again to afford employment to all the people of the United States. In other words, we cannot afford to depart from a tried and established basis of taxation and embark on an untried experimental program because we are aggravated or annoyed somewhat on account of the conduct of a relatively few corporations in the United States."

SUPREME COURT OF THE UNITED STATES.

No. 723.—October Term, 1937.

Guy T. Helvering, Commissioner, etc., Petitioner, vs. National Grocery Company.	On Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

[May 16, 1938.]

Mr. Justice Brandeis delivered the opinion of the Court.

National Grocery Company is a New Jersey corporation, which operates chain stores. Since 1911 it has had $200,000 capital stock, all owned beneficially by Henry Kohl. In the year ending January 31, 1931, the corporation's books showed a net profit of $682,850.38, after paying $104,000 to Kohl as salary and the regular federal corporation income tax of 12 per cent. Its surplus, as shown by its books, increased during the year from $7,245,824.26 to $7,938,965.54; that is $693,141.28. It paid no dividend.

Section 104 of the Revenue Act of 1928, c. 852, 45 Stat. 814, provides:

"(a) If any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected and paid for each taxable year upon the net income of such corporation a tax equal to 50 per centum of the amount thereof, which shall be in addition to the tax imposed by Section 13. . . .

"(b) The fact . . . that the gains or profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax."

The Commissioner of Internal Revenue, having found that the corporation had been availed of for the purpose of preventing the imposition of the surtax upon Kohl by permitting the gains and profits to accumulate, assessed upon it, under Section 104, a deficiency tax of $477,322.81 for the tax year, in addition to the regular corporation income tax, which had been paid. This amount, together with $37.87 admittedly due, constitutes the total deficiency assessment of $477,360.68.

The corporation petitioned for a redetermination by the Board of Tax Appeals. Before the Board a large volume of evidence

was introduced which had not been submitted to the Commissioner. It detailed, among other things, the financial history of the business from its inception. There were 35 elaborate exhibits, many of them prepared from the books with the co-operation of the counsel for the corporation and for the Commissioner. Twenty-four of the exhibits were introduced by the taxpayer; eleven by the Commissioner. The taxpayer also presented as witnesses Kohl and the treasurer of the corporation, who testified orally to the history of the business, its practices and aims; local bank officials who testified as experts to the wisdom of accumulating the profits; and other experts who testified to the depreciation in 1930 of the market value of the securities held by the corporation and of its real estate. The Board, by a bare majority,[1] sustained the Commissioner's determination. In stating its conclusions, it found as follows:

"We find as a fact that the petitioner's accumulation of earnings was far in excess of the 'reasonable needs' of the corporate business.

"We are also of opinion that the evidence of record does not rebut the prima facie presumption created by the statute that the accumulation of earnings beyond the 'reasonable needs of the business' was for the purpose of preventing the imposition of the surtax upon its sole stockholder. . . .

"Upon the evidence before us we have made the finding that the petitioner was 'availed of' during the fiscal year ended January 31, 1931, for the purpose of preventing the imposition of the surtax upon its sole stockholder 'through the medium of permitting its gains and profits to accumulate instead of being divided or distributed.'"

The corporation then petitioned for a review by the Circuit Court of Appeals. It reversed the order of the Board; and did so on the ground that there was before the Board "no proof, substantial or otherwise, to support its imposition of" the tax. Certiorari was sought by the Commissioner, who urged that in so deciding the court had departed from the accepted and usual course of judicial proceedings. We granted certiorari because of the importance in the administration of the revenue laws of the matter presented. 302 U. S. —.

[1] Mr. Mellott, who stated the views of the minority, said: "This being a 'fact case', it is with some reluctance that I reach a conclusion at variance with that of the Member who heard the testimony of the witnesses and had the advantage of observing their manner and demeanor while testifying. . . ."

The corporation makes here two contentions in support of the judgment which were not discussed by the Court of Appeals. It challenges the constitutionality of the statute and also urges that in holding that there were "gains and profits" the Commissioner and the Board of Tax Appeals misconstrued the statute. These contentions will be considered before examining the alleged lack of evidence to support the findings of the Board.

First. The National Grocery Company concedes that Section 104 is constitutional as applied to a corporation organized for the purpose of preventing the imposition of surtaxes upon its shareholders;[2] but urges five reasons why it should be held void as applied to a legitimate business corporation which is "availed of" for the forbidden purpose. None of these reasons is sound.

1. It is said that the statute violates the Tenth Amendment because it interferes with the power to declare or to withhold dividends—a power which the State conferred upon the corporation. The statute in no way limits the powers of the corporation. It merely lays the tax upon corporations which use their powers to prevent imposition upon their stockholders of the federal surtaxes. "Congress in raising revenue has incidental power to defeat obstructions to that incidence of taxes which it chooses to impose." *United Business Corporation* v. *Commissioner*, 62 F. (2d) 754, 756.

Kohl's personal income tax for the calendar year 1931 was $32,034.74. If he had included in his personal return of taxable income the corporation's entire net income for the fiscal year 1930-1931, an additional tax upon him of over $115,000 would have been due;[3] and no tax would have been assessable against the corporation

[2] Citing United Business Corporation *v.* Commissioner, 62 F. (2d) 754 (C. C. A. 2); A. D. Saenger, Inc. *v.* Commissioner, 84 F. (2d) 23 (C. C. A. 5); Almours Securities, Inc. *v.* Commissioner, 91 F. (2d) 427 (C. C. A. 5); Williams Inv. Co. *v.* United States, 3 F. Supp. 225 (Ct. Cl.). See also United States *v.* R. C. Tway Coal Co., 75 F. (2d) 336 (C. C. A. 6); Keck Inv. Co. *v.* Commissioner, 77 F. (2d) 244 (C. C. A. 9).

[3] It is not possible to calculate what Kohl's exact additional surtax liability would have been had he included the corporation's income for 1930-1931 in his personal return for 1931, since that return is not in evidence. A minimum figure, however, may be obtained. The corporation's "net income", as defined in § 104, was $954,645.62. There must be deducted from this $103,654.47 for corporation income tax; and $100,000 was distributed as a dividend in 1931 and included in computing the tax paid by Kohl in that year. Even assuming that the remaining $750,991.15 would have constituted his entire net income for 1931, and that the maximum deduction of 15% of this amount for charitable contributions could have been taken, a surtax of $119,328.50 would have been due.

under Section 104. For the statute expressly provides, in paragraph (d), that the corporation shall not be so taxed, if the stockholders make the return required to ensure the surtax:

"(d) The tax imposed by this section shall not apply if all the shareholders of the corporation include (at the time of filing their returns) in their gross income their entire distributive shares, whether distributed or not, of the net income of the corporation for such year. Any amount so included in the gross income of a shareholder shall be treated as a dividend received. Any subsequent distribution made by the corporation out of the earnings or profits for such taxable year shall, if distributed to any shareholder who has so included in his gross income his distributive share, be exempt from tax in the amount of the share so included."

2. It is said that the statute is unconstitutional because the liability imposed is not a tax upon income, but a penalty designed to force corporations to distribute earnings in order to create a basis for taxation against the stockholders. If the business had been carried on by Kohl individually all the year's profits would have been taxable to him. If, having a partner, the business had been carried on as a partnership, all the year's profits would have been taxable to the partners individually, although these had been retained by the partnership undistributed. See *Heiner* v. *Mellon*, Nos. 144 and 145, decided May 16, 1938. Kohl, the sole owner of the business, could not by conducting it as a corporation, prevent Congress, if it chose to do so, from laying on him individually the tax on the year's profits.[4] If it preferred, Congress could lay the tax upon the corporation, as was done by Section 104. The penal nature of the imposition does not prevent its being valid, as the

[4] The first statute which provided for taxation where corporate profits are accumulated for the purpose of preventing the imposition of surtaxes upon stockholders was the Tariff Act of 1913, Section 2A, subdiv. 1, 38 Stat. 166. In that Act, in the Revenue Act of 1916, § 3; 39 Stat. 758, and in the Revenue Act of 1918, § 220, 40 Stat. 1072, the tax was laid upon the shareholder. In all later Revenue Acts, the tax is laid upon the corporation. 1921 Act, § 220, 42 Stat. 247; 1924 Act, § 220, 43 Stat. 277; 1926 Act, § 220, 44 Stat. 34; 1928 Act, § 104, 45 Stat. 814; 1932 Act, § 104, 47 Stat. 195; 1934 Act, § 102, 48 Stat. 702; 1936 Act, § 102, 49 Stat. 1676.

The Revenue Acts of 1918 and 1921, §§ 218(e) and 218(d), respectively, also taxed the shareholders of "personal service corporations" like partners. Section 112(k) of the Revenue Act of 1932 and § 112(i) of the Acts of 1934 and 1936 provide for the disregard of the corporate entity in certain cases where foreign corporations are used for the purpose of avoiding federal taxes. And § 201 of the Revenue Act of 1937, 50 Stat. 818, provides that the adjusted undistributed net income of foreign personal holding companies must be included in the gross income of their United States shareholders. Compare also Southern Pac. Co. v. Lowe, 247 U. S. 330, 336; Gulf Oil Corp. v. Lewellyn, 248 U. S. 71; Gregory v. Helvering, 293 U. S. 465.

tax was otherwise permissible under the Constitution. Compare *Helvering* v. *Mitchell*, 303 U. S. —.

3. It is said that Section 104 is unconstitutional because the liability is laid upon the mere purpose to prevent imposition of the surtaxes, not upon the accomplishment of that purpose; and that, thus, it is a direct tax on the state of mind. But this is not so. The tax is laid "upon the net income of such corporation". The existence of the defined purpose is a condition precedent to the imposition of the tax liability, but this does not prevent it from being a true income tax within the meaning of the Sixteenth Amendment. The instances are many in which purpose or state of mind determines the incidence of an income tax.[5]

4. It is said that Section 104 as applied deprived the corporation of its property without due process of law; that it is unreasonable, arbitrary and capricious in that no standard or formula is specified to guide the Commissioner in assessing, or the corporate directors in avoiding, the additional tax; that it is assessed retroactively; and that it is unfair to non-assenting minority stockholders. The prescribed standard is not too vague. As Judge Learned Hand said in *United Business Corporation* v. *Commissioner*, 62 F. (2d) 754, 756:

"Standards of conduct, fixed no more definitely, are common in the law; the whole law of torts is pervaded by them; much of its commands are that a man must act as the occasion demands, the standard being available to all. The vice of fixing maximum prices is that it requires recourse to standards beyond ascertainment by sellers, by which therefore they cannot in practice regulate their

[5] For example, § 293(b) of the Revenue Act of 1928 provides that if any part of a deficiency is due to "fraud with intent to evade tax", there shall be an "addition to the tax" of 50% of the deficiency. Helvering v. Mitchell, 303 U. S. —. Whether a payment received is compensation within § 22(a) or is a gift within § 22(b)(3) is largely a matter of intention. Compare Bogardus v. Commissioner, 302 U. S. 34, 45. Similarly, the deductibility of losses under § 23(e) may depend upon whether the taxpayer's motive in entering into the transaction was primarily profit. Compare Heiner v. Tindle, 276 U. S. 582; Stuart v. Commissioner, 84 F. (2d) 368 (C. C. A. 1); Goldsborough v. Burnet, 46 F. (2d) 432 (C. C. A. 4); Beaumont v. Helvering, 73 F. (2d) 110, 113 (App. D. C.); Dresser v. United States, 55 F. (2d) 499 (Ct. Cl.). And § 112(k) of the Revenue Act of 1932 (and § 112(i) of the Acts of 1934 and 1936) provides that a foreign corporation shall not be considered as a corporation for purposes of certain of the non-recognition provisions of that section unless "it has been established to the satisfaction of the Commissioner that such exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

dealings. That is not true of the reasonable needs of a business, which is immediately within the ken of the managers, the supposititious standard, though indeed objective, being as accessible as those for example of the prudent driving of a motor car, or of the diligence required in making a ship seaworthy, or of the extent of proper inquiry into the solvency of a debtor."

Clearly retroactive assessment is no more objectionable here than in the case of penalties for fraud or negligence. *Helvering* v. *Mitchell, supra.* And since no minority stockholders are here involved, the last objection need not be considered. *Castillo* v. *McConnico,* 168 U. S. 674, 680; *Atlantic Refining Co.* v. *Virginia,* 302 U. S. 22, 27.

5. It is said that Section 104 is void because it delegates to the Commissioner legislative power. The statute provides that if the corporation is availed of for the forbidden purpose, the tax "shall be levied, collected, and paid"; and certain facts are made prima facie evidence of the existence of this purpose. No power is delegated to the Commissioner save that of finding facts upon evidence.

Second. The corporation contends, as a matter of statutory construction, that Section 104 was not applicable because there were no "gains and profits" within the tax year. Conceding that net income of $863,787.22 was earned,[6] it asserts that there were "no gains and profits" because the depreciation in the securities owned, none of which were sold, exceeded $2,000,000. The argument is that the word "gains" was not used as synonymous with "profits", but to express contemplated unrealized increases or accession in net worth of the assets; and that assessability under Section 104 depends not upon gains or profits—but upon the aggregate of gains (or losses) and profits, since prudent directors would take these into consideration in determining whether a dividend should be declared. Depreciation in any of the assets is evidence to be considered by the Commissioner and the Board in determining the issue of fact whether the accumulation of profits was in excess of the reasonable needs of the business. But obviously depreciation in the market value of securities which the corporation continues to hold does not, as matter of law, preclude a finding that the accumulation of the year's profits was in excess of the reasonable needs of the business.

[6] The corporation reported in its return an income of $863,471.67. This was increased by the Commissioner to $863,787.22, and is not now disputed.

Third. There was ample evidence to support the findings of the Board of Tax Appeals. The corporation held on January 31, 1930, bonds and stocks valued at $2,779,718.07; on January 31, 1931 it held $2,989,452.74—an increase of $209,734.67. The list of these bonds and stocks showed that they were in no way related to a grocery business.[7] That there was no need of accumulating any part of the year's earnings for the purpose of financing the business was shown by the balance sheet. Comparing the cash on hand with the outstanding indebtedness, it appears that the $1,332,332.28 cash on hand January 31, 1930 exceeded the $1,161,121.96 accounts payable, notes and mortgage, by $171,210.32. On January 31, 1931, the excess of cash over accounts payable was $1,136,820.55. These were then only $269,140.49; and the cash on hand was $1,405,961.04. The notes payable and the mortgage had been discharged.

That the purpose of accumulating this huge surplus was to escape the imposition upon Kohl of surtaxes, was indicated by the following facts. The $4,395,413.78 aggregate of bonds, stocks, and excess cash January 31, 1931, represents about four-fifths of the total accumulation of the surplus profits during the last ten years, which amounted to $5,742,455.35.[8] If the surplus profits of the fiscal year 1930-1931 had been distributed as dividends, the additional surtaxes payable thereon by Kohl in the year 1931 would have been at least $90,744.56, and for the preceding nine years would have aggregated $1,240,852.30.[9]

Further evidence to support the Board's findings that in the tax year dividends were omitted and the surplus accumulated in order to enable Kohl to escape these surtaxes is furnished by the following facts: Kohl drew his salary of $104,000 a year; and that sum, as an

[7] The stock held January 31, 1931, of the aggregate cost of $2,676,061.47, consisted of issues of 147 different corporations. Of industrials there were 61. Of public utilities, 27. Of insurance companies, 18. Of investment trusts, 13. Of banks and trust companies, 28. There were, besides, government, municipal, railroad, public utility, industrial and miscellaneous bonds which cost $313,391.27.

[8] The profits for these years (after deducting federal corporation income taxes paid) are listed in note 9, *infra*.

[9] Kohl's individual returns were made on a calendar year cash basis. For the fiscal year here in question, January 31, 1930 to January 31, 1931, the corporation's books showed a profit of $682,850.38 after deducting Kohl's salary and the 12% corporation income tax paid. A dividend of $100,000 was paid in 1931. Had the remaining $582,850.38 been entirely distributed in that year, Kohl would have incurred an additional surtax liability of $90,744.56, even if it be assumed that the additional distribution would have

expense of the business, was deducted before calculating the corporation's profit on which it paid taxes under Section 13. He needed personally further sums and took these in the form of loans. In the tax year Kohl borrowed from the corporation $140,000. His aggregate indebtedness on January 31, 1931 for borrowings during seven years, was $610,000. As was stated in *United Business Corporation* v. *Commissioner, supra,* p. 755: "These loans are incompatible with a purpose to strengthen the financial position of the petitioner, but entirely accord with a desire to get the equivalent of his dividends under another guise."[10]

Since Kohl was the sole owner of the corporation, the business would have been as well protected against unexpected demands for capital, and assured of capital for the purpose of any possible expansion, by his personal ownership of the securities as by the corporation's owning them. Moreover, no conceivable expansion could

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constituted his entire net income for that year and that the 15% maximum charitable contributions deduction could have been taken. (It is impossible to calculate what his exact surtax liability for 1931 would have been, inasmuch as his personal return for that year is not in evidence.) Compare note 3, *supra.*

If the corporation had distributed its profits for each fiscal year immediately after its close on January 31, Kohl's additional surtax liability for the nine preceding years would have been as follows:

Year	Fiscal Year in Which Distribution Was Earned by Corporation	Book Profits of Corporation Less Federal Corporation Income Tax Paid	Kohl's Computed Net Income Including Distribution	Kohl's Computed Surtax	Surtax Actually Paid	Difference
1930	Jan. 31, 1929–Jan. 31, 1930	$713,181.62	$703,972.52	$132,454.50	$8,022.37	$124,432.13
1929	Jan. 31, 1928–Jan. 31, 1929	769,945.96	839,766.18	159,613.24	8,441.14	151,172.10
1928	Jan. 31, 1927–Jan. 31, 1928	707,289.60	775,363.34	146,732.67	8,411.75	138,320.92
1927	Jan. 31, 1926–Jan. 31, 1927	498,879.08	569,440.88	105,548.18	8,481.21	97,066.97
1926	Jan. 31, 1925–Jan. 31, 1926	508,837.06	584,937.44	108,647.49	9,113.16	99,534.33
1925	Jan. 31, 1924–Jan. 31, 1925	528,022.34	614,044.69	114,468.94	9,004.24	105,464.70
1924	Jan. 31, 1923–Jan. 31, 1924	547,483.80	546,921.87	188,788.75	2,820.60	185,968.15
1923	Jan. 31, 1922–Jan. 31, 1923	461,106.88	441,832.17	191,876.09	2,069.50	189,806.59
1922	Jan. 31, 1921–Jan. 31, 1922	324,908.63	362,986.22	152,453.11	3,366.70	149,086.41
						$1,240,852.80

[10] Compare A. D. Saenger, Inc. v. Commissioner, 84 F. (2d) 23 (C. C. A. 5); United States v. R. C. Tway Coal Co., 75 F. (2d) 336, 340 (C. C. A. 6).

have utilized so large a surplus.[11] The high taxes were first imposed in 1919.[12] After that time no dividend was paid until after the close of the taxable year here involved.

Thus, independently of the presumption prescribed in Section 104(b) there was ample evidence to support the Board's findings.

Fourth. The Court of Appeals, instead of limiting its review to ascertaining whether there was evidence to support the Board's findings and decision, made on all the evidence, as upon a trial *de novo,* in effect, an independent determination of the matters which had been in issue before the Board. The court was without power to do so. *Helvering* v. *Rankin,* 295 U. S. 123, 131-32. To draw inferences, to weigh the evidence and to declare the result was the function of the Board. *Hulburd* v. *Commissioner,* 296 U. S. 300, 306; *Elmhurst Cemetery Co.* v. *Commissioner,* 300 U. S. 37, 40.

Fifth. The court expressed the opinion that the Board failed to consider relevant and controlling facts, that it relied upon improper evidence in reaching its conclusion, and that it failed to make the findings required by the statute. There is nothing in the record to justify that view. The findings quoted above are specific. The Board was not obliged to accept as true Kohl's statement of his intention and purposes; or to accept as sound the opinion of his experts. It was error to reverse the decision of the Board. There is no occasion to remand the case to it for further consideration.

Reversed.

Mr. Justice McREYNOLDS and Mr. Justice BUTLER are of opinion that the judgment below should be affirmed.

Mr. Justice CARDOZO and Mr. Justice REED took no part in the consideration or decision of this case.

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[11] In the ten years the number of stores in the chain had been increased from 358 to 815. Even on Kohl's own estimate that "including everything you have to have about $5000 per store", this expansion could account for only $2,285,000 of the $5,742,455.35 of profits accumulated over that period.

[12] The Revenue Act of 1918, 40 Stat. 1057, which was not enacted until February 24, 1919, imposed a surtax of as much as 65% on income in excess of $1,000,000. The maximum rate under the Revenue Act of 1916, 39 Stat. 756, was only 13% on income in excess of $2,000,000.